Cash accounts include U.S. and foreign coin and currency on hand and in transit, clearings, and cash items.

CASH

Every bank maintains a certain amount of U.S. currency and some may have foreign currency on hand. To avoid having excess nonearning assets and to minimize exposure to misappropriation and robbery, each bank should establish a policy to maintain cash balances at the minimum levels necessary to serve its customers. The amount will vary from bank to bank depending on anticipated needs of customers and the availability of replenishment monies, with a reasonable allowance made for unusual demands.

Foreign currency may not be included in cash positions for management purposes where the amounts are not significant. However, the coin and currency of other countries are foreign currency assets, as are loans or nostro accounts, and should be included in the foreign currency positions.

CLEARINGS

Clearings are checks, drafts, notes, and other items that a bank has cashed or received for deposit that are drawn on other local banks and cleared directly with them. These items can usually be exchanged more efficiently among local banks than through correspondent banks or the Federal Reserve System. Many communities with two or more banks have formally organized clearinghouse associations, which have adopted rules governing members in the exchange of checks. Clearinghouse associations often extend their check-exchange arrangements to other nearby cities and towns. In most banks, clearings will be found in the department responsible for processing checks.

Proof and transit were once two separate functions in a bank: the proving of work (proof) and the sending of out-of-town cash items (transit) for collection. Most banks have now combined these two functions. Proof and transit may be performed by any combination of tellers or proof clerks, a separate proof and transit department, a check-processing department, an out-clearing department, or some other department that is characteristic of the area of the country where the bank operates. The functions may be centralized or decentralized, manual or automated, depending on the size of the bank and the volume of transactions. The volume of clearings may be so great that the bank's proof operations are conducted after time deadlines for transaction posting or courier delivery. In these cases, daily clearings customarily are determined as of a specific cutoff time. Checks processed to that time are carried in one day's totals, and checks processed after that time are carried in the following day's totals. However, no matter who performs the function or how large the bank, the objectives of a proof and transit system are the same:

- To forward items for collection so that funds are available as soon as possible.
- To distribute all incoming checks and deposits to their destinations.
- To establish whether deposit totals balance with the totals shown on deposit tickets.
- To prove the totals of general ledger entries and other transactions.
- To collect data for computing the individual customer's service charges and determining the availability of the customer's funds.
- To accomplish the assigned functions at the lowest possible cost.

CASH ITEMS

Cash items are checks or other items in the process of collection that are payable in cash upon presentation. A separate control of all cash items is usually maintained on the bank's general ledger and, if applicable, on the international division general ledger. The ledger is supported by a subsidiary record of individual amounts and other pertinent data. Cash items and the related records are usually in the custody of one employee at each banking office.

In their normal daily operations, banks have an internal charge, on the general ledger, to total demand deposits not charged to individual accounts because of insufficient funds, computer misreads, or other problems. Commonly known as return items or rejected or unposted debits, these items may consist of checks received in the ordinary course of business, loan payment debits, and other debit memos. In some banks, return items are separated by the bookkeepers and an entry is made reclassifying them to a separate asset account entitled ‘‘bookkeepers’ return items.’’ Other banks do not use a separate asset account; instead, the bookkeepers include the items in a subsidiary control account in the individual demand deposit ledgers. In that case, the account would have a debit balance and would be credited when the bank processes items for posting or returns the checks to their source.

Since bookkeepers’ return items are usually processed and posted to an individual account or returned to their source on the next business day, the balance of the bookkeepers’ return items account should represent the total of only one day’s returned items.

When data processing systems are used, the common practice is to post all properly encoded debit items, regardless of whether an overdraft is created. The resulting preliminary overdraft list, together with the items charged, is subsequently reviewed by bank employees, and unapproved items are reversed and separated as bookkeepers’ return items. The total of the resulting final overdraft list becomes the final overdraft figure shown on the general ledger. The examination of overdrafts is discussed in ‘‘Deposit Accounts,’’ section 3000 of this manual. The examination of international overdrafts is discussed in ‘‘Due from Banks,’’ ‘‘Borrowed Funds,’’ and ‘‘International—Foreign Exchange,’’ sections 2010, 3010, and 7100, respectively.

Several types of cash items should be considered ‘‘cash items not in the process of collection’’ and shown in an appropriate ‘‘other assets’’ account. Some examples are (1) items that are payable upon presentation but which the bank has elected to accumulate and periodically forward to the payor, such as Series EE bonds or food stamps; (2) items that are not immediately payable in cash upon presentation; and (3) items that were not paid when presented and require further collection effort.

In addition to those items carried in the separate ‘‘cash items’’ account on the general ledger, most banks will have several sources of internal float in which irregular cash items can be concealed. Such items include any memoranda slips; checks drawn on the bank; checks returned by other banks; checks of directors, officers, employees, and their interests; checks of affiliates; debits purporting to represent currency or coin shipments; notes, usually past due; and all aged and unusual items of any nature that might involve fictitious entries, manipulations, or uncollectible accounts.

CURRENCY TRANSACTIONS

The Financial Recordkeeping and Reporting of Currency and Foreign Transactions regulation, 31 CFR 103, requires financial institutions to maintain records that might be useful in criminal, tax, or regulatory investigations. The regulation also seeks to identify persons who attempt to avoid payment of taxes through transfers of cash to or from foreign accounts. The examination procedures for determining compliance with the regulation require the examiner to ascertain the quality of the bank’s auditing procedures and operating standards relating to financial recordkeeping.[1] Examiners also determine the adequacy of written policies and bank training programs. The Financial Recordkeeping and Reporting of Currency and Foreign Transactions checklist (refer to the *Bank Secrecy Act Examination Manual*) is to be used in checking compliance and for reporting apparent violations. Any violations noted should be listed with appropriate comments in the report of examination. Inadequate compliance could result in a cease-and-desist order to effect prompt compliance with the statute.

1. Section 208.14 of Regulation H establishes procedures to ensure that state member banks establish and maintain procedures reasonably designed to ensure and monitor compliance with the regulation.

1. To determine if the policies, practices, procedures, and internal controls regarding ‘‘cash accounts’’ are adequate.
2. To determine if bank officers and employees are operating in conformance with the established guidelines.
3. To determine the scope and adequacy of the audit function.
4. To determine compliance with laws and regulations.
5. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

1. If selected for implementation, complete or update the Cash Accounts section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal/external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned to that area of examination, and determine if appropriate corrections have been made.
4. Scan the general ledger cash accounts for any unusual items or abnormal fluctuations. Investigate any such items and document any apparent noncompliance with policies, practices and procedures for later review with appropriate management personnel.
5. Obtain teller settlement sheet recap or similar document as of the examination date and agree to the general ledger. Scan for reasonableness and conformity to bank policy.
6. Obtain detailed listings of cash items, including any bank items which are carried in the general ledger under ''other assets,'' agree listings to general ledger balances and scan for propriety and conformity to bank policy.
7. Test compliance with Regulation P (12 CFR 216) by:
   a. Selecting teller and banking office cash balance sheets and determining that balances are within currency limits established.
   b. Selecting bait money and agreeing serial numbers to applicable records.
   c. Reviewing documentation showing training sessions held since the preceding examination.
   d. Performing any visual inspections deemed appropriate.
   e. Analyzing the bank's system of security and protection against external crimes. Guidance for this analysis is provided in the Internal Control Questionnaire in this section of the manual.
   f. Determining, through discreet corroborative inquiry of responsible bank officials and review of documentation, whether a security program that equals or exceeds the standards prescribed by Regulation P (12 CFR 216.4) is in effect and that the annual compliance report and any other reports requested by the Federal Reserve System have been filed.
8. Review compliance with the Financial Recordkeeping and Reporting of Currency and Foreign Transactions Act, 31 CFR 103.
9. Review tellers' over and short accounts for recurring patterns and any large or unusual items and follow up as considered necessary. Investigate differences centered in any one teller or banking office. Determine whether corrective action has been taken, if required.
10. Determine, by discreet corroborative inquiry of responsible bank officials and review of documentation, whether defalcations and/or mysterious disappearances of cash since the preceding examination have been properly reported pursuant to current requirements of the Board of Governors.
11. Review foreign currency control ledgers and dollar book value equivalents for:
    a. Accuracy of calculations and booking procedures.
    b. Unusual fluctuations.
    c. Concentrations.
    d. Unusual items.
12. Review international division revaluation calculations and procedures.
13. Review the following items with appropriate management personnel (or prepare a memo to other examining personnel for their use in reviewing with management):
    a. Internal control exceptions and deficiencies in, or noncompliance with, written policies, practices and procedures.
    b. Uncorrected audit deficiencies.
    c. Violations of law.
    d. Inaccurate booking of U.S. dollar book value equivalents for foreign currencies.
    e. Inaccurate revaluation calculations and procedures performed by cash account operations staff.
14. Prepare comments on deficiencies or

violations of law noted above for inclusion in the examination report.

15. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls policies practices and procedures for cash accounts. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

CASH ON HAND

*1. Do all tellers, including relief tellers, have sole access to their own cash supply and are all spare keys kept under dual control?
*2. Do tellers have their own vault cubicle or controlled cash drawer in which to store their cash supply?
3. When a teller is leaving for vacation or for any other extended period of time is that teller's total cash supply counted?
4. Is each teller's cash verified periodically on a surprise basis by an officer or other designated official (if so, is a record of such count retained)?
*5. Are cash drawers or teller cages provided with locking devices to protect the cash during periods of teller's absence?
6. Is a specified limit in effect for each teller's cash?
*7. Is each teller's cash checked daily to an independent control from the proof or accounting control department?
8. Are teller differences cleared daily?
9. Is an individual cumulative over and short record maintained for all persons handling cash and is the record reviewed by management?
10. Does the teller prepare and sign a daily proof sheet detailing currency, coin and cash items?
*11. Are large teller differences required to be reported to a responsible official for clearance?
12. Is there a policy against allowing teller "kitties"?
*13. Are teller transactions identified through use of a teller stamp?
*14. Are teller transfers made by tickets or blotter entries which are verified and initialed by both tellers?
15. Are maximum amounts established for tellers cashing checks or allowing withdrawal from time deposit accounts without officer approval?
16. Does the currency at each location include a supply of bait money?
17. Are tellers provided with operational guidelines on check cashing procedures and dollar limits?
18. Is a record maintained showing amounts and denominations of reserve cash?
*19. Is reserve cash under dual custody?
*20. Are currency shipments:
    a. Prepared and sent under dual control?
    b. Received and counted under dual control?
*21. If the bank utilizes teller machines:
    a. Is the master key controlled by someone independent of the teller function?
    b. Is the daily proof performed by someone other than the teller?
    c. Are keys removed by the teller during any absence?
*22. Is dual control maintained over mail deposits?
23. Is the night depository box under dual lock system?
24. Is the withdrawal of night deposits made under dual control?
25. Regarding night depository transactions:
    a. Are written contracts in effect?
    b. Are customers provided with lockable bags?
    c. Are the following procedures completed with two employees present:
        • Opening of the bags?
        • Initial recording of bag numbers, envelope numbers and depositors' names in the register?
        • Counting and verification of the contents?
*26. Regarding vault control:
    a. Is a register maintained which is signed by the individuals opening and closing the vault?
    b. Are time clock settings checked by a second officer?
    c. Is the vault under dual control?
    d. Are combinations changed periodically and every time there is a change in custodianship?

27. Are tellers prohibited from processing their own checks?
*28. Are tellers required to clear all checks from their funds daily?
*29. Are tellers prevented from having access to accounting department records?
*30. Are teller duties restricted to teller operations?

CASH DISPENSING MACHINES

*31. Is daily access to the automated teller machine (ATM) made under dual control?
*32. When maintenance is being performed on a machine, with or without cash in it, is a representative of the bank required to be in attendance?
*33. Are combinations and keys to the machines controlled (if so, indicate controls)?
34. Do the machines and the related system have built-in controls that:
    a. Limit the amount of cash and number of times dispensed during a specified period (if so, indicate detail)?
    b. Capture the card if the wrong PIN (personal identification number) is consecutively used?
35. Does the machine automatically shut down after it experiences recurring errors?
36. Is lighting around the machine provided?
37. Does the machine capture cards of other banks or invalid cards?
38. If the machine is operated ‘‘off line,’’ does it have negative file capability for present and future needs which includes lists of lost, stolen or other undesirable cards which should be captured?
39. Is use of an ATM by an individual customer in excess of that customer's past history indicated on a ‘‘suspicious activity’’ report to be checked out by bank management (three uses during past three days as compared with a history of one use per month)?
40. Have safeguards been implemented at the ATM to prevent disclosure of a customer's PIN during use by others observing the PIN pad?
41. Are ‘‘fish-proof’’ receptacles provided for customers to dispose of printed receipts, rather than insecure trash cans, etc.?
42. Does a communication interruption between an ATM and the central processing unit trigger the alarm system?
43. Are alarm devices connected to all automated teller machines?
44. For on-line operations, are all messages to and from the central processing unit and the ATM protected from the central processing unit and the ATM protected from tapping, message insertion, modification of message or surveillance by message encryption (scrambling techniques)? (One recognized encryption formula is the National Bureau of Standards Algorithm.)
*45. Are PINs mailed separately from cards?
*46. Are bank personnel who have custody of cards prohibited from also having custody of PINs at any stage (issuance, verification, or reissuance)?
47. Are magnetic stripe cards encrypted (scrambled) using an adequate algorithm (formula) including a total message control?
48. Are encryption keys, i.e., scramble plugs, under dual control of personnel not associated with operations or card issuance?
*49. Are captured cards under dual control of persons not associated with bank operation card issuance or PIN issuance?
*50. Are blank plastics and magnetic stripe readers under dual control?
51. Are all cards issued with set expiration dates?
52. Are transaction journals provided that enable management to determine every transaction or attempted transaction at the ATM?

CASH ITEMS

*53. Are returned items handled by someone other than the teller who originated the transaction?
54. Does an officer or other designated individual review the disposition of all cash items over a specified dollar limit?
55. Is a daily report made of all cash items, and is it reviewed and initialed by the bank's operations officer or other designated individual?
56. Is there a policy requiring that all cash items uncollected for a period of 30 days be charged-off?

57. Do the bank's present procedures forbid the holding of overdraft checks in the cash item account?
58. Are all cash items reviewed at least monthly at an appropriate level of management?
*59. Are cash items recommended for charge-off reviewed and approved by the board of directors, a designated committee thereof or an officer with no operational responsibilities?

PROOF AND TRANSIT

60. Are individuals working in the proof and transit department precluded from working in other departments of the bank?
61. Is the handling of cash letters such that:
    a. They are prepared and sent on a daily basis?
    b. They are photographed before they leave the bank?
    c. Copy of proof or hand-run tape is properly identified and retained?
    d. Records of cash letters sent to correspondent banks are maintained with identification of the subject bank, date and amount?
    e. Remittances for cash letters are received by employees independent of those who send out the cash letters?
62. Are all entries to the general ledger either originated or approved by the proof department?
63. Are all entries prepared by the general ledger and/or customer accounts department reviewed by responsible supervisory personnel other than the person preparing the entry?
64. Are errors detected by the proof operator in proving deposits corrected by another employee or designated officer?
65. Are all postings to the general ledger and subsidiary ledgers supported by source documents?
66. Are returned items:
    *a. Handled by an independent section of the department or delivered unopened to personnel not responsible for preparing cash letters or handling cash?
    b. Reviewed periodically by responsible supervisory personnel to determine that items are being handled correctly by this section and are clearing on a timely basis?
    *c. Scrutinized for employee items?
    d. Reviewed for large or repeat items?
67. Are holdover items:
    a. Appropriately identified in the general ledger?
    *b. Handled by an independent section of the department?
    c. Reviewed periodically by responsible supervisory personnel to determine that items are clearing on a timely basis?
68. Does the proof and transit department maintain a procedures manual describing the key operating procedures and functions within the department?
*69. Are items reported missing from cash letter promptly traced and a copy sent for credit?
*70. Is there a formal system to ensure that work distributed to proof machine operators is formally rotated?
71. Are proof machine operators prohibited from:
    a. Filing checks or deposit slips?
    b. Preparing deposit account statements?
72. Are proof machine operators instructed to report unusually large deposits or withdrawals to a responsible officer (if so, over what dollar amount $__________)?

REGULATION P (12 CFR 216)—COMPLIANCE QUESTIONNAIRE

73. Has a security officer been designated by the board of directors in accordance with Regulation P (12 CFR 216.2)?
74. Has a security program been developed and implemented in accordance with Regulation P (12 CFR 216.4)?
75. Do security devices give a general level of protection that is at least equivalent to the standards described in appendix A of Regulation P (if not, does the bank maintain a statement substantiating its reasons for such noncompliance __________)?
76. Has installation, maintenance and operation of security devices been in accordance with Regulation P (12 CFR 216.3)?
77. Do vaults, safes, ATMs, and night depositories meet or exceed the minimum standards described in appendix A of Regulation P (if not, does the bank maintain a

statement substantiating its reasons for such noncompliance ________)?

31 CFR 103—COMPLIANCE QUESTIONNAIRE

78. Is the bank in compliance with the Financial Recordkeeping and Reporting Regulations?

INTERNATIONAL DIVISION

*79. Are foreign currency control ledgers and dollar book value equivalents posted accurately?

*80. Is each foreign currency revalued at least monthly and are profit and loss entries passed on to the appropriate income accounts?

*81. Are revaluation calculations, including the rates used, periodically reviewed for accuracy by someone other than the foreign currency tellers?

*82. Does the internal auditor periodically review for accuracy revaluation calculations, including the verification of rates used and the resulting general ledger entries?

CONCLUSION

83. Is the foregoing information considered an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.

84. Based on a composite evaluation as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate). A separate evaluation should be made for each area, i.e., cash on hand, cash items, etc.

INTRODUCTION

Banks maintain deposits in other banks to facilitate the transfer of funds. Those bank assets, known as ‘‘due from bank deposits’’ or ‘‘correspondent bank balances’’[1] are a part of the primary, uninvested funds of every bank. A transfer of funds between banks may result from the collection of cash items and cash letters, the transfer and settlement of securities transactions, the transfer of participating loan funds, the purchase or sale of federal funds, and many other causes.

In addition to deposits kept at the Federal Reserve Bank and with correspondent banks, a bank may maintain interest-bearing time deposits with international banks. Those deposits are a form of investment, and relevant examination considerations are included in ‘‘Acquisition and Management of Nontrading Securities and Derivative Instruments,’’ section 2020, and ‘‘International—Due from Banks—Time,’’ section 7070, of this manual.

Banks also use other banks to provide certain services that can be performed more economically or efficiently by another facility because of its size or geographic location. These services include processing of cash letters, packaging loan agreements, performing EDP services, collecting out-of-area items, providing safekeeping for bank and customer securities, exchanging foreign currency, and providing financial advice in specialized loan areas. When the service is one-way, the receiving bank usually maintains a minimum balance at the providing bank to compensate in full or in part for the services received.

DEPOSITS WITH OTHER DEPOSITORY INSTITUTIONS

Section 206.3 of Regulation F (12 CFR 206) requires FDIC-insured depository institutions to adopt written policies and procedures to address the risk arising from exposure to a correspondent, and to prevent excessive exposure to any individual correspondent. These policies and procedures should take into account the financial condition of a correspondent, and the size, form, and maturity of the exposure. Section 206.4(a) of Regulation F stipulates that any FDIC-insured depository institution must limit its interday credit exposure to an individual correspondent that is not ‘‘adequately capitalized’’[2] to 25 percent of the institution’s total capital.[3] For a more detailed discussion of Regulation F, refer to SR-93-36 (‘‘Examiner Guidelines for Regulation F—Interbank Liabilities,’’ June 18, 1993).

BALANCES WITH FEDERAL RESERVE BANKS

All state member banks are required by Regulation D (12 CFR 204) to keep reserves equal to specified percentages of the deposits on their books. These reserves are maintained in the form of vault cash or deposits with the Federal Reserve Bank. The Federal Reserve Bank monitors the deposits of each bank to determine that reserves are kept at required levels. The reserves provide the Federal Reserve System with a means of controlling the nation’s money supply. Changes in the level of required reserves affect the availability and cost of credit in the economy. The examiner must determine that the information supplied to the Federal Reserve Bank for computing reserves is accurate.

The Monetary Control Act of 1980 enables a nonmember financial institution to borrow from the Reserve Bank’s discount window on the same terms and conditions as member banks. For member banks, loan transactions are usually effected through their reserve account. For nonmember banks, the Reserve Bank typically requires the institution to open a special account called a clearing account. The loan transactions are then processed through the clearing account.

1. Balances due from such institutions include all interest-bearing and non-interest-bearing balances, whether in the form of demand, savings, or time balances, including certificates of deposit, but excluding certificates of deposit held in trading accounts.

2. Refer to section 206.5(a) of Regulation F for the capital ratios necessary for a correspondent bank to be considered adequately capitalized.

3. The Board may waive this requirement if the primary federal supervisor of the insured institution advises the Board that the institution is not reasonably able to obtain necessary services, including payment-related services and placement of funds, without incurring exposure to a correspondent in excess of the otherwise applicable limit.

However, in some instances, the Reserve Bank may allow a nonmember institution to process discount loan transactions through the account of a member bank. In most of these isolated cases, a transaction of a nonmember institution is being processed through the account of the bank with which the nonmember institution has a correspondent relationship.

Under the reserve account charge agreements used by most Federal Reserve banks, the member bank's reserve account may be charged if the nonmember bank defaults on the loan processed through the member bank's account. Since member banks may not act as the guarantor of the debts of another, member banks may only legally enter into revocable reserve account charge agreements. Revocable agreements allow the member bank, at its option, to revoke the charge and thus avoid liability for the debt of the nonmember correspondent. In contrast, irrevocable charge agreements constitute a binding guarantee of the nonmember correspondent's debt and generally cannot be entered into by a member bank. Banks that enter into revocable charge agreements should establish written procedures to ensure their ability to make prudent, timely decisions.

DEPOSIT BROKERS

On the asset side of the balance sheet, examiners should review the activities of banks that place deposits through money brokers. These banks should have sufficient documentation to, among other things, verify the amounts and terms of individual deposits and the names of depository institutions in which the deposits are placed. Banks should also be able to demonstrate that they have exercised appropriate credit judgment with respect to each depository institution in which they have placed funds. Deficiencies in this area could constitute an unsafe or unsound banking practice. A more detailed discussion of brokered deposits is included in ''Deposit Accounts,'' section 3000 of this manual.

DUE FROM FOREIGN BANKS—DEMAND

Due from foreign banks—demand or nostro accounts are handled in the same manner as due from domestic bank accounts, except that the balances due are generally denominated in foreign currency.

A bank must be prepared to make and receive payments in foreign currencies to meet the needs of its international customers. This can be accomplished by maintaining accounts (nostro balances) with banks in foreign countries in whose currencies receipts and payments are made.

Nostro balances may be compared to an inventory of goods and must be supervised in the same manner. For example, payment for the importation to the United States of goods manufactured in France can be made through a U.S. bank's French franc account with another bank in France. Upon payment in France, the U.S. bank will credit its nostro account with the French bank and charge its U.S. customer's dollar account for the appropriate amount in dollars. Conversely, the exportation of U.S. goods to France results in a debit to the U.S. bank's French correspondent account.

The first transaction results in an outflow of the U.S. bank's ''inventory'' of French francs, while the second transaction results in an inflow of French francs. The U.S. bank must maintain adequate balances in its nostro accounts to meet unexpected needs and to avoid overdrawing those accounts for which interest must be paid. However, the bank should not maintain excessive idle nostro balances that do not earn interest, causing a loss of income.

The U.S. bank also runs risks by being either long or short in a particular foreign currency or by maintaining undue gaps. Losses could result if that currency appreciates or depreciates significantly or if the bank must purchase or borrow the currency at a higher rate.

Excessive nostro overages and shortages can be avoided by entering into spot and forward exchange contracts to buy or sell such nostro inventories. Those contracts are discussed in ''International—Foreign Exchange,'' section 7100. However, it is important to remember that all foreign currency transactions, except over-the-counter cash trades, are settled through nostro accounts. Therefore, the volume of activity in those accounts may be substantial and the accounts must be properly controlled.

In addition, an account service known as a payable-through account is being marketed by U.S. banks, Edge corporations, and the U.S. branches and agencies of foreign banks to foreign banks that otherwise would not have the ability to offer their customers access to the U.S. banking system. This account service, also referred to by other names such as pass-through accounts and pass-by accounts, involves a U.S. banking entity's opening of a deposit account for the foreign bank. Policies and procedures should be developed to guard against the possible improper or illegal use of payable-through account facilities by foreign banks and their customers. Examination procedures relating to this area are part of the *Bank Secrecy Act Examination Manual*.

1. To determine if the policies, practices, procedures, and internal controls regarding due from banks are adequate.
2. To determine if bank officers and employees are operating in conformance with the established guidelines.
3. To determine that all due from accounts are reasonably stated and represent funds on deposit with other banks.
4. To evaluate the credit quality of banks with whom demand accounts are maintained.
5. To determine the scope and adequacy of the audit coverage.
6. To determine compliance with laws, rulings, and regulations.
7. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law, rulings, or regulations have been noted.

1. If selected for implementation, complete or update the Due From Banks Internal Control Questionnaire.
2. Determine the scope of the examination, based on the evaluation of internal controls and the work performed by internal/external auditors.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned ‘‘Internal Control,’’ and determine if corrections have been accomplished.
4. Scan the most recent bank-prepared reconcilements for any unusual items and determine that closing balances listed on reconcilements agree with the general ledger and with the balance shown on the cut-off statement if one has been obtained.
5. If the bank's policy for charge-off of old open items provides for exceptions in extenuating circumstances, review excepted items and determine if charge-off is appropriate.
6. If the bank has no policy for charge-off of old open items, review any items which are large or unusual or which have been outstanding for over two months, along with related correspondence, and determine if charge-off is appropriate.
7. Test the bank's calculation of its Federal Reserve requirement and determine that reports are accurate and complete by:
   a. Performing a limited review of a sample of line items if the bank has effective operating procedures and has an audit program covering the required reports.
   b. Performing a detailed review of all line items if the bank has not established operating procedures or does not have an audit program covering the required reports.
8. Confer with the examiner assigned to check for compliance with the laws and regulations relating to insider loans at correspondent banks and loans to insiders of correspondent banks (subpart B of Regulation O and title VIII of FIRA) and either provide a list, or verify a bank supplied list, of correspondent banks. (This effort should be coordinated with the examiner assigned to ‘‘Deposit Accounts’’ to avoid duplication of work.)
9. Review the maximum deposit balance established for each due from bank account and determine if the maximum balance:
   a. Is established after consideration of compensating balance requirements resulting from commitments or credit lines made available to the bank or its holding company. Coordinate this effort with examiner assigned ‘‘Bank-Related Organizations.’’
   b. Appears to be related to loans of executive officers or directors or to loans which have been used to acquire stock control of the bank under examination.
      • If such due from accounts are detected, provide full details of the account to the examiner assigned to check for compliance with the law relating to loans to insiders of correspondent banks (title VIII of FIRA).
10. Determine the existence of any concentrations of assets with other banks. Include correspondent accounts, time deposits and any federal funds sold in computation. For concentrations exceeding 25 percent of the bank's capital structure, forward the information to examiners assigned ‘‘Concentrations of Credit’’ for possible inclusion in the report of examination.

Note: Procedures 11 through 21 apply to due from foreign banks—demand (nostro accounts).

11. Obtain or prepare a trial balance (including local currency book values) of due from foreign banks—demand by bank customer and:
    a. Agree or reconcile balances to department controls and the general ledger.
    b. Review reconciling items for reasonableness.
12. Using the appropriate sampling technique, select demand account banks for examination.
13. Prepare credit line sheets to include:
    a. Customer's aggregate due from banks—

demand liability in foreign currency amount and local currency equivalent.
b. Amount of customer's line designated by the bank.
c. Frequency of recent overdrawn nostro accounts.

(Overdrawn nostro accounts as they relate to foreign exchange activities are discussed in the International—Foreign Exchange section. Also, the examiner assigned ''Borrowed Funds'' must obtain (or prepare) a listing of overdrawn nostro accounts for inclusion in the borrowing section of the report of examination.)

d. Past compliance with customer's line limitation as determined from review of liability ledger records.

14. Obtain from the examiner assigned ''International—Loan Portfolio Management,'' schedules on the following, if they are applicable to the due from foreign banks—demand:
   a. Delinquencies.
   b. Miscellaneous loan debit and credit suspense accounts.
   c. Criticized shared national credits.
   d. Interagency Country Exposure Review Committee credits.
   e. Loans criticized during the previous examination.
   f. Information on directors, officers and their interests, as contained in statements required under Regulation O.
   g. Specific guidelines in the bank policy relating to due from banks—demand.
   h. Current listing of due from foreign banks—demand approved customer lines.
   i. Any useful information resulting from the review of the minutes of the loan and discount committee or any similar committee.
   j. Reports furnished to the board of directors.
15. Review the information received and perform the following for:
   a. Miscellaneous loan debit and credit suspense accounts:
      - Discuss with management any large or old items.
      - Perform additional procedures as deemed appropriate.
   b. Interagency Country Exposure Review Committee Credits:
      - Compare the schedule to the trial balance to determine which due from foreign banks—demand deposits are portions of Interagency Country Exposure Review Committee credits.
      - For each due from foreign bank—demand deposit so identified, transcribe appropriate information to line sheets and forward the information to the examiner assigned ''International—Loan Portfolio Management.''
   c. Loans criticized during the previous examination (due from foreign banks—demand portion):
      - Determine the disposition of the due from foreign banks—demand so criticized by transcribing:
         — Current balance and payment status, or
         — Date the deposit was paid and the source of repayment.
16. Transcribe or compare information from the above schedules to credit line sheets, where appropriate, and indicate any cancelled bank lines.
17. Prepare credit line cards for any due from foreign banks—demand not in the sample which, based on information derived from the above schedules, requires in-depth review.
18. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts and loan areas and together decide who will review the borrowing relationship. Pass or retain completed credit line cards.
19. Obtain credit files for all due from foreign banks—demand for whom credit line cards were prepared and complete credit line cards where appropriate. To analyze the loans, perform the procedures set forth in step 14 of the International—Due From Banks–Time section.
20. By reviewing appropriate bank records, determine that:
   a. Profit or losses resulting from revaluation adjustment on net open positions spot are passed properly to the respective due from foreign bank—demand (nostro) account (usually monthly).
   b. At the delivery of the ''swap'' forward contract, proper entries are made to the respective due from foreign bank—demand (nostro) and swap adjustment accounts.

21. Determine compliance with laws, regulations and rulings pertaining to due from foreign banks—demand activities by performing the following for:
    a. Reporting of Foreign Exchange Activities:
        - Determine that Foreign Currency Forms FC-1, FC-2, FC-1a and FC-2a, as required, are submitted to the Department of the Treasury under the provisions of 31 CFR 128.
        - Check that copies of those forms are forwarded by each state member bank to the Federal Reserve at each filing time specified in 31 CFR 128.

    Note: Due from foreign banks—demand (nostro) deposits will be reviewed, discussed with appropriate bank officers, and prepared in suitable report form by the examiner assigned ''International—Due From Banks–Time'', if the bank maintains international due from banks—time and/or call money deposits.

22. Forward list of due from banks accounts to the examiner assigned to ''Investment Securities'' and to ''Loan Portfolio Management.''
23. Consult with the examiner assigned ''Asset/Liability Management'' and provide the following, if requested:
    a. A listing, by maturity and amount, of due from banks—time deposits.
    b. The amounts of due from banks—demand deposits that exceed the required reserve balance at the Federal Reserve Bank and that exceed the working balances at correspondent banks.
24. Discuss with appropriate officer(s) and prepare in suitable report form of:
    a. Cancelled due from foreign banks—demand deposit lines that are unpaid.
    b. Violations of laws, regulations and rulings.
    c. Internal control exceptions and deficiencies, or noncompliance with written policies, practices and procedures.
    d. Any items to be considered for charge-off.
    e. Uncorrected audit deficiencies.
    f. Due from foreign banks—demand deposits not supported by current and complete financial information.
    g. Due from foreign banks—demand deposits on which documentation is deficient.
    h. Concentrations.
    i. Criticized loans (portions applicable to due from foreign banks—demand deposits).
    j. Due from foreign banks—demand deposits which for any other reason are questionable as to quality and ultimate collection.
    k. Other matters regarding condition of the department.
25. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures for due from bank accounts. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICIES FOR DUE FROM BANK DOMESTIC AND FOREIGN—DEMAND ACCOUNTS

1. Has the board of directors, consistent with its duties and responsibilities, adopted written policies for due from bank accounts that:
   a. Provide for periodic review and approval of balances maintained in each such account?
   b. Indicate person(s) responsible for monitoring balances and the application of approved procedures?
   c. Establish levels of check-signing authority?
   d. Indicate officers responsible for approval of transfers between correspondent banks and procedures for documenting such approval?
   e. Indicate the supervisor responsible for regular review of reconciliations and reconciling items?
   f. Indicate that all entries to the accounts are to be approved by an officer or appropriate supervisor and that such approval will be documented?
   g. Establish time guidelines for charge-off of old open items?
2. Are the policies for due from bank accounts reviewed at least annually by the board or the board's designee to determine their adequacy in light of changing conditions?

BANK RECONCILEMENTS

3. Are bank reconcilements prepared promptly upon receipt of the statements?

*4. Are bank statements examined for any sign of alteration and are payments or paid drafts compared with such statements by the persons who prepare bank reconcilements (if so, skip question 5)?

*5. If the answer to question 4 is no, are bank statements and paid drafts or payments handled before reconcilement only by persons who do not also:
   a. Issue drafts or official checks and prepare, add or post the general or subsidiary ledgers?
   b. Handle cash and prepare, add or post the general ledger or subsidiary ledgers?

*6. Are bank reconcilements prepared by persons who do not also:
   a. Issue drafts or official checks?
   b. Handle cash?
   c. Prepare general ledger entries?

7. Concerning bank reconcilements:
   a. Are amounts of paid drafts or repayments compared or tested to entries on the ledgers?
   b. Are entries or paid drafts examined or reviewed for any unusual features?
   c. Whenever a delay occurs in the clearance of deposits in transit, outstanding drafts and other reconciling items, are such delays investigated?
   d. Is a record maintained after an item has cleared regarding the follow-up and reason for any delay?
   e. Are follow-up and necessary adjusting entries directed to the department originating or responsible for the entry for correction with subsequent review of the resulting entries by the person responsible for reconcilement?
   f. Is a permanent record of the account reconcilement maintained?
   g. Are records of the account reconcilements safeguarded against alteration?
   h. Are all reconciling items clearly described and dated?
   i. Are details of account reconcilement reviewed and approved by an officer or supervisory employee?
   j. Does the person performing reconcilements sign and date them?
   k. Are reconcilement duties for foreign

demand accounts rotated on a formal basis?

DRAFTS

8. Are procedures in effect for the handling of drafts so that:
   *a. All unissued drafts are maintained under dual control?
   b. All drafts are prenumbered?
   c. A printer's certificate is received with each supply of new prenumbered drafts?
   d. A separate series of drafts is used for each bank?
   e. Drafts are never issued payable to cash?
   f. Voided drafts are adequately cancelled to prevent possible reuse?
   *g. A record of issued and voided drafts is maintained?
   *h. Drafts outstanding for an unreasonable period of time (perhaps six months or more) are placed under special controls?
   i. All drafts are signed by an authorized employee?
   *j. The employees authorized to sign drafts are prohibited from doing so before a draft is completely filled out?
   *k. If a check-signing machine is used, controls are maintained to prevent its unauthorized use?

FOREIGN CASH LETTERS

9. Is the handling of foreign cash letters such that:
   a. They are prepared and sent on a daily basis?
   b. They are copied or photographed prior to leaving the bank?
   c. A copy of proof or hand run tape is properly identified and retained?
   d. Records of foreign cash letters sent to correspondent banks are maintained, identifying the subject bank, date and amount?

FOREIGN RETURN ITEMS

10. Are there procedures for the handling of return items so that:
    *a. They are delivered unopened and reviewed by someone who is not responsible for preparation of cash letters?
    b. All large unusual items or items on which an employee is listed as maker, payee or endorser are reported to an officer?
    c. Items reported missing from cash letters are promptly traced and a copy sent for credit?

FOREIGN EXCHANGE ACTIVITIES

*11. Are persons handling and reconciling due from foreign bank—demand accounts excluded from performing foreign exchange and position clerk functions?
*12. Is there a daily report of settlements made and other receipts and payments of foreign currency affecting the due from foreign bank—demand accounts?
*13. Is each due from foreign bank—-demand foreign currency ledger revalued monthly and are appropriate profit or loss entries passed to applicable subsidiary ledgers and the general ledger?
*14. Does an officer not preparing the calculations review revaluations of due from foreign bank—demand ledgers, including the verification of rates used and the resulting general ledger entries?

OTHER—FOREIGN

*15. Are separate dual currency general ledger or individual subsidiary accounts maintained for each due from foreign bank—demand account, indicating the foreign currency balance and a U.S. dollar (or local currency) equivalent balance?
16. Do the above ledger or individual subsidiary accounts clearly reflect entry and value dates?
17. Are the above ledger or individual subsidiary accounts balanced to the general ledger on a daily basis?
18. Does international division management receive a daily trial balance of due from foreign bank—demand customer balances by foreign currency and U.S. dollar (or local currency) equivalents?

OTHER

19. Is a separate general ledger account or individual subsidiary account maintained for each due from bank account?
20. Are overdrafts of domestic and foreign due from bank accounts properly recorded on the bank's records and promptly reported to the responsible officer?
21. Are procedures for handling the Federal Reserve account established so that:
    a. The account is reconciled on a daily basis?
    b. Responsibility is assigned for assuring that the required reserve is maintained?
    c. Figures supplied to the Federal Reserve for use in computing the reserve requirement are reviewed to ensure they do not include asset items ineligible for meeting the reserve requirement, and that all liability items are properly classified as required by Regulation D and its interpretations?
22. Does the foregoing information constitute an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly and indicate any additional examination procedures deemed necessary.
23. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

This section provides guidance on the management of a depository institution's investment and end-user activities. The guidance applies to all securities in *held-to-maturity* and *available-for-sale* accounts as defined in the Statement of Financial Accounting Standards No. 115 (FAS 115), all certificates of deposit held for investment purposes, and all off-balance-sheet (OBS) derivative contracts not held in trading accounts (end-user derivative contracts).[1] The guidance also covers all securities used for investment purposes, including, money market instruments, fixed and floating-rate notes and bonds, structured notes, mortgage pass-through and other asset-backed securities, and mortgage-derivative products. All end-user derivative instruments used for nontrading purposes, such as swaps, futures, and options, are also discussed.

Institutions must ensure that their investment and end-user activities are permissible and appropriate within established limitations and restrictions on bank holdings of these instruments. Institutions should also employ sound risk-management practices consistently across these varying product categories, regardless of their legal characteristics or nomenclature. This section provides examiners with guidance on—

- the permissibility and appropriateness of securities holdings by state member banks;
- sound risk-management practices and internal controls used by banking institutions in their investment and end-user activities;
- review of securities and derivatives acquired by the bank's international division and overseas branches for its own account, as well as on the bank's foreign equity investments that are held either directly or through Edge Act corporations;
- banking-agency policies on certain high-risk mortgage derivative products; and
- unsuitable investment practices.

1. In general terms, derivatives are financial contracts whose value derives from the value of one or more underlying assets, interest rates, exchange rates, commodities, or financial or commodity indexes.

LIMITATIONS AND RESTRICTIONS ON SECURITIES HOLDINGS

Many states extend the same investment authorities available to national banks to their chartered banks—often with direct reference. In turn, the security investments of national banks are governed by the seventh paragraph of 12 USC 24 (section 5136 of the Revised Statutes) and by the investment securities regulation of the Office of the Comptroller of the Currency (OCC).

Under 12 USC 24, an ''investment security'' is defined as a debt obligation that is not predominantly speculative. A security is not predominantly speculative if it is rated investment-grade. An ''investment-grade security'' has been rated in one of the four highest rating categories by two or more nationally recognized statistical rating organizations (one rating may suffice if the security has only been rated by one organization). For example, securities rated AAA, AA, A, and BBB by Standard and Poor's and Aaa, Aa, A, A-1, Baa-1, and Baa by Moody's are considered investment-grade. In the case of split ratings—different ratings from different rating organizations—the lower rating applies. Although the analyses of major rating agencies are basically sound and updated frequently, bank personnel should keep in mind that ratings are only evaluations of probabilities. To determine appropriate credit limits for a particular counterparty, the bank should supplement bond ratings with its own credit analysis of the issuer. (See table 1 for a summary of rating systems.)

Table 1—Summary of Rating Systems

Standard & Poor's	*Moody's*	*Description*
	Bank-Quality Investments	
AAA	Aaa	Highest grade obligations
AA	Aa	High grade obligations
A	A-1, A	Upper medium grade
BBB	Baa-1, Baa	Medium grade, on the borderline between definitely sound obligations and those containing predominantly speculative elements
	Speculative and Defaulted Issues	
BB	Ba	Lower medium grade with only minor investment characteristics
B	B	Low grade, default probable
Ccc, cc, c, D	Caa, Ca, c	Lowest rated class, defaulted, extremely poor prospects

Bank-Eligible Securities

The OCC's investment-securities regulation, which was revised in 1996, identifies five basic types of investment securities (types I, II, III, IV, and V) and establishes limitations on a bank's investment in those types of securities based on the percentage of capital and surplus that such holdings represent. For calculating concentration limits, the term ‘‘capital and surplus’’ includes the balance of a bank's allowance for loan and lease losses not included in tier 2 capital. Table 2 summarizes bank-eligible securities and their investment limitations.

Table 2—Summary of New Investment-Type Categories

Type Category	*Characteristics*	*Limitations*
Type I securities	• U.S. government securities • General obligations of a state or political subdivision • Obligations backed by the full faith and credit of the U.S. government • FHLB, FNMA, and FHLMC debt	No limitations on banks' investment, dealing, or underwriting abilities.
Type II securities	• State obligations for housing, university, or dormitory purposes • Obligations of development banks • Debt of Tennessee Valley Authority • U.S. Postal Service	Banks may deal in, underwrite, or invest subject to the limitation that the aggregate par value of the obligation of any one obligor may not exceed 10 percent of a bank's capital and surplus.
Type III securities	• An investment security that does not qualify as a type I, II, IV, or V • Municipal revenue bonds • Corporate bonds	The aggregate par value of a bank's purchases and sales of the securities of any one obligor may not exceed 10 percent of a bank's capital and surplus. Banks may not deal in or underwrite these securities.
Type IV securities	• Small business–related securities • Residential and commercial mortgage–related securities rated Aaa and Aa	For securities rated Aaa or Aa, no investment limitations. For securities rated A or Baa, the aggregate par value of a bank's purchases and sales of the securities of any one obligor may not exceed 25 percent of a bank's capital and surplus. For mortgage-related securities, no investment limitations. A bank may deal in type IV securities which are fully secured by type I securities with limitation.
Type V securities	• Asset-backed securities (credit card, auto, home equity, student loan, manufactured housing) • Residential and commercial mortgage–related securities rated below Aa, but still investment-grade	The aggregate par value of a bank's purchases and sales of the securities of any one obligor may not exceed 25 percent of a bank's capital and surplus.

Type I securities are those debt instruments that national and state member banks can deal in, underwrite, purchase, and sell for their own accounts without limitation. Type I securities are obligations of the U.S. government or its agencies, general obligations of states and political subdivisions, and mortgage-related securities. A bank may purchase type I securities for its own account subject to no limitations, other than the exercise of prudent banking judgment (see 12 USC 24 (7) and 15 USC 78(c)(a)(41)).

Type II securities are those debt instruments that national and state member banks may deal in, underwrite, purchase, and sell for their own accounts subject to a 10 percent limitation of a bank's capital and surplus for any one obligor. Type II investments include obligations issued by the International Bank for Reconstruction and Development; the Inter-American Development Bank; the Asian Development Bank; the Tennessee Valley Authority; the United States Postal Service; obligations issued by any state or political subdivision for housing, university, or dormitory purposes; and other issuers specifically identified in 12 USC 24 (7).

Type III is a residual securities category consisting of all types of investment securities not specifically designated to another security ‘‘type’’ category. Banks cannot deal in or underwrite type III securities, and their holdings of these instruments are limited to 10 percent of the bank's capital and surplus for any one obligor.

Type IV securities include the following asset-backed securities (ABS) that are fully secured by interests in pools of loans made to numerous obligors:

- investment-grade residential mortgage-related securities offered or sold pursuant to section 4(5) of the Securities Act of 1933 (15 USC 77d(5))
- residential mortgage-related securities as described in section 3(a)(41) of the Securities Exchange Act of 1934 (15 USC 78c(a)(41)) are rated in one of the two highest investment-grade rating categories
- investment-grade commercial mortgage securities offered or sold pursuant to section 4(5) of the Securities Act of 1933 (15 USC 77d(5))
- commercial mortgage securities as described in section 3(a)(41) of the Securities Exchange Act of 1934 (15 USC 78c(a)(41)) are rated in one of the two highest investment-grade rating categories
- investment-grade, small-business-loan securities as described in section 3(a)(53)(A) of the Securities Exchange Act of 1934 (15 USC 78c(a)(53)(A))

For all type IV commercial and residential mortgage securities and for type IV small-business-loan securities rated in the top two rating categories, there is no limitation on the amount a bank can purchase or sell for its own account. Type IV investment-grade, small-business-loan securities that are not rated in the top two rating categories are subject to a limit of 25 percent of a bank's capital and surplus for any one issuer. In addition to being able to purchase and sell type IV securities, subject to the above limitation, a bank may deal in those type IV securities which are fully secured by type I securities.

Type V securities consist of all ABS that are not type IV securities. Specifically, they are defined as marketable, investment-grade-rated securities that are not type IV and are ‘‘fully secured by interests in a pool of loans to numerous obligors and in which a national bank could invest directly.’’ They include securities backed by auto loans, credit card loans, home equity loans, and other assets. Also included are residential and commercial mortgage securities as described in section 3(a)(41) of the Securities Exchange Act of 1934 (15 USC 78c(a)(41)) which are not rated in one of the two highest investment-grade rating categories, but are still investment-grade. A bank may purchase or sell type V securities for its own account provided the aggregate par value of type V securities issued by any one issuer held by the bank does not exceed 25 percent of the bank's capital and surplus.

As mentioned above, type III securities represent a residual category. The OCC requires a national bank to determine (1) that the type III instrument it plans to purchase is marketable and of sufficiently high investment quality and (2) that the obligor will be able to meet all payments and fulfill all the obligations it has undertaken in connection with the security. For example, junk bonds, which are often issued to finance corporate takeovers, are usually not considered to be of investment quality because they are predominately speculative and have limited marketability.

The purchase of type II and III securities is limited to 10 percent of equity capital and reserves for each obligor when the purchase is based on adequate evidence of the maker's ability to perform. That limitation is reduced to 5 percent of equity capital and reserves for all obligors in the aggregate when the judgment of the obligor's ability to perform is based predominantly on ''reliable estimates.'' The term ''reliable estimates'' refers to projections of income and debt-service requirements or conditional ratings when factual credit information is not available and when the obligor does not have a record of performance. Securities purchased subject to the 5 percent limitation may, in fact, become eligible for the 10 percent limitation once a satisfactory financial record has been established. Additional limitations on specific securities that have been ruled eligible for investment are detailed in 12 CFR 1.3. The par value, not the book value or purchase price, of the security is the basis for computing the limitations. However, the limitations do not apply to securities acquired through debts previously contracted.

OCC regulations specifically provide for *separate* type I, type II, type III, type IV, and type V limits. In the extreme, therefore, banks can lend 15 percent of their capital to a corporate borrower, buy the borrower's corporate bonds amounting to another 10 percent of capital and surplus (type III securities), and purchase the borrower's ABS up to an additional 25 percent of capital (type V securities), for a total exposure of 50 percent of the bank's capital and surplus. This could be expanded even further if the borrower also issued highly rated type IV securities upon which there is no investment limitation. However, exposure to any one issuer of 25 percent or more should be considered a credit concentration, and banks are expected to carefully consider why exposures in excess of 25 percent do not entail an undue concentration. (See table 2 for a summary of the new investment-type categories.)

Classification of Securities

Sub-investment-quality securities are those in which the investment characteristics are distinctly or predominantly speculative. This group includes securities in grades below the four highest grades and unrated securities of equivalent quality, defaulted securities, and sub-investment-quality stocks. As noted in table 3, securities in grades below the four highest grades and unrated securities of equivalent quality will be valued at market price. The market value will be classified substandard, and the depreciation will be classified doubtful. Depre-

Table 3—Security Classifications

	Classification		
Type of Security	*Substandard*	*Doubtful*	*Loss*
Investment-quality	XXX	XXX	XXX
Sub-investment-quality, except—	Market value	Market depreciation	XXX
Sub-investment-quality, municipal general obligations	Book value	XXX	XXX
Defaulted securities and sub-investment-quality stocks, except—	Market value	XXX	Market depreciation
Defaulted municipal general obligations:			
Interim	XXX	Book value	XXX
Final, i.e., when market is reestablished	Market value	XXX	Market depreciation

ciation in defaulted securities and sub-investment-quality stocks will generally be classified loss; market value will be classified substandard.

An exception to the above is to be made for municipal general obligations, which are backed by the credit and taxing power of the issuer. The entire book value of sub-investment-quality municipal general obligations that are not in default should be classified substandard. In the event of a default of a municipal general obligation, a period of time is usually necessary to permit the market for these defaulted securities to stabilize or for the issuer to put in place budgetary, tax, or other actions that may eliminate the default or otherwise improve the post-default value of the securities. The market for the defaulted securities will be periodically reviewed by the regulatory authorities. Upon a determination that a functioning market has been reestablished, depreciation on defaulted municipal general obligations will be classified as loss. During this interim, the book value of all defaulted municipal general obligation securities will be classified doubtful.

Banks are required to maintain adequate credit information in their files to demonstrate that they are exercising prudent judgment in their securities and derivative transactions. Unrated securities must be evaluated by the bank to determine if the instrument is a bank-eligible investment. Examiners must ensure that the bank's methodology for evaluating unrated securities is sound. All credit-related information and analyses should be retained for as long as the security remains in the bank's portfolio.

The transfer of low-quality securities from one depository institution to another may be made to avoid detection and classification during regulatory examinations, and may be accomplished through participations, purchases or sales, and asset swaps with other affiliated or nonaffiliated financial institutions. Broadly defined, low-quality securities include depreciated or sub-investment-grade securities of questionable quality. Situations in which an institution appears to be concealing low-quality securities to avoid examination scrutiny and possible classification represent an unsafe and unsound activity. Further, this type of transfer between affiliated banks is a violation of section 23A of the Federal Reserve Act.

Any situations involving the transfer of low-quality or questionable securities should be brought to the attention of Reserve Bank supervisory personnel who, in turn, should notify the local office of the primary federal regulator of the other depository institution involved in the transaction. For example, if an examiner determines that a state member bank or holding company has transferred or intends to transfer low-quality securities to another depository institution, the Reserve Bank should notify the recipient institution's primary federal regulator of the transfer. The same notification requirement holds true if an examiner determines that a state member bank or holding company has acquired or intends to acquire low-quality securities from another depository institution. This procedure applies to transfers involving savings and loan associations and savings banks, as well as commercial banking organizations.

Situations may arise when transfers of securities are undertaken for legitimate reasons. In these cases, the securities should be properly recorded on the books of the acquiring institution at their fair value on the date of transfer. If the transfer was with the parent holding company or a nonbank affiliate, the records of the affiliate should be reviewed as well.

Permissible Stock Holdings

The purchase of securities convertible into stock at the option of the issuer is prohibited (12 CFR 1.10). Other than as specified in table 4, banks are prohibited from investing stock.

Table 4—Permitted Stock Holdings by Member Banks

Type of Stock	*Authorizing Statute and Limitation*
Federal Reserve Bank	Federal Reserve Act, sections 2 and 9 (12 USC 282 and 321) and Regulation I (12 CFR 209)— Subscription must equal 6 percent of the bank's capital and surplus, 3 percent paid in.

Type of Stock	*Authorizing Statue and Limitation*
Safe deposit corporation	12 USC 24—15 percent of capital and surplus.
Corporation holding bank premises	Federal Reserve Act, section 24A (12 USC 371(d))—100 percent of capital stock. Limitation includes total direct and indirect investment in bank premises in any form (such as loans). Maximum limitation may be exceeded with permission of the Federal Reserve Bank for state member banks and the Comptroller of the Currency for national banks.
Small business investment company	Small Business Investment Act of August 21, 1958, section 302(b) (15 USC 682(b))—Banks are prohibited from acquiring shares of such a corporation if, upon making the acquisition, the aggregate amount of shares in small business investment companies then held by the bank would exceed 5 percent of its capital and surplus.
Edge and agreement corporations and foreign banks	Federal Reserve Act, sections 25 and 25A (12 USC 601 and 618)—The aggregate amount of stock held in all such corporations may not exceed 10 percent of the member bank's capital and surplus. Also, the member bank must possess capital and surplus of $1 million or more before acquiring investments pursuant to section 25.
Banking service corporation	Bank Service Corporation Act of 1958, section 2(a) (12 USC 1861 and 1862)—10 percent of capital and surplus. Limitation includes total direct and indirect investment in any form. No insured banks may invest more than 5 percent of their total assets.
Federal National Mortgage Corporation	National Housing Mortgage Association Act of 1934, section 303(f) (12 USC 1718(f))—No limit.
Bank's own stock	12 USC 83—Shares of the bank's own stock may not be acquired or taken as security for loans, except as necessary to prevent loss from a debt previously contracted in good faith. Stock so acquired must be disposed of within six months of the date of acquisition.
Corporate stock acquired through debt previously contracted (DPC) transaction	Case law has established that stock of any corporation debt may be acquired to prevent loss from a debt previously contracted in good faith. See Oppenheimer v. Harriman National Bank & Trust Co. of the City of New York, 301 US 206 (1937). However, if the stock is not disposed of within a reasonable time period, it loses its status as a DPC transaction and becomes a prohibited holding under 12 USC 24(7).
Operations subsidiaries	12 CFR 250.141—Permitted if the subsidiary is to perform, at locations at which the bank is authorized to engage in business, functions that the bank is empowered to perform directly.
State housing corporation incorporated in the state in which the bank is located	12 USC 24—5 percent of its capital stock, paid in and unimpaired, plus 5 percent of its unimpaired surplus fund when considered together with loans and commitments made to the corporation.

Type of Stock	*Authorizing Statue and Limitation*
Agricultural credit corporation	12 USC 24—20 percent of capital and surplus unless the bank owns over 80 percent. No limit if the bank owns 80 percent or more.
Government National Mortgage Association	12 USC 24—No limit.
Student Loan Marketing Association	12 USC 24—No limit.
Bankers' banks	12 USC 24—10 percent of capital stock and paid-in and unimpaired surplus. Bankers' banks must be insured by the FDIC, owned exclusively by depository institutions, and engaged solely in providing banking services to other depository institutions and their officers, directors, or employees. Ownership shall not result in any bank's acquiring more than 5 percent of any class of voting securities of the bankers' bank.
Mutual funds	12 USC 24(7)—Banks may invest in mutual funds as long as the underlying securities are permissible investments for a bank.
Community development corporation	Federal Reserve Act, section 9, paragraph 23 (12 USC 338a)—Up to 10 percent of capital stock and surplus subject to 12 CFR 208.21.

EVALUATING RISK MANAGEMENT AND INTERNAL CONTROLS

Examiners are expected to conduct an adequate evaluation of the risk-management process used to acquire and manage the securities and derivative contracts used in nontrading activities. In conducting this analysis, examiners should evaluate the following four key elements of a sound risk-management process:

- active board and senior management oversight
- adequate risk-management policies and limits
- appropriate risk-measurement and reporting systems
- comprehensive internal controls

This section identifies basic factors that examiners should consider in evaluating these elements for investment and end-user activities; it reiterates and supplements existing guidance and directives on the use of these instruments for nontrading purposes as provided in various supervisory letters and examination manuals.[2]

In evaluating an institution's risk-management process, examiners should consider the nature and size of its holdings. Examiner judgment plays a key role in assessing the adequacy of an institution's risk-management process for securities and derivative contracts. Examiners should focus on evaluating an institution's understanding of the risks involved in the instruments it holds. Regardless of any responsibility, legal or otherwise, assumed by a dealer or counterparty for a particular transaction, the acquiring insti-

2. Existing policies and examiner guidance on various supervisory topics applicable to securities and off-balance-sheet instruments can be found in this manual, the *Commercial Bank Examination Manual,* the *Bank Holding Company Suervision Manual,* and the *Trust Activities Examination Manual,* as well as in various supervision and regulation (SR) letters, including SR-90-16, ''Implementation of Examination Guidelines for the Review of Asset Securitization Activities''; SR-91-4, ''Inspection of Investment-Adviser Subsidiaries of Bank Holding Companies''; SR-92-1, ''Supervisory Policy Statement on Securities Activities''; SR-93-69, ''Risk Management and Internal Controls for Trading Activities''; and SR-95-17, ''Evaluating the Risk Management and Internal Controls of Securities and Derivative Contracts Used in Nontrading Activities.'' Examiners of U.S. branches and agencies of foreign banks should take the principles included in these guidelines into consideration in accordance with the procedures set forth in the *Examination Manual for Branches and Agencies of Foreign Banking Organizations.*

tution is ultimately responsible for understanding and managing the risks of the transactions into which it enters. Failure of an institution to adequately understand, monitor, and evaluate the risks involved in its securities or derivative positions, either through lack of internal expertise or inadequate outside advice, constitutes an unsafe and unsound banking practice.

As with all risk-bearing activities, institutions should fully support the risk exposures of nontrading activities with adequate capital. Banking organizations should ensure that their capital positions are sufficiently strong to support all the risks associated with these activities on a fully consolidated basis and should maintain adequate capital in all affiliated entities engaged in these activities. In evaluating the adequacy of an institution's capital, examiners should consider any unrecognized net depreciation or appreciation in an institution's securities and derivative holdings. Further consideration should also be given to the institution's ability to hold these securities and thereby avoid recognizing losses.

Board of Directors and Senior Management Oversight

Active oversight by the institution's board of directors and relevant senior management is critical to a sound risk-management process. Examiners should ensure that these individuals are aware of their responsibilities and that they adequately perform their appropriate roles in overseeing and managing the risks associated with nontrading activities involving securities and derivative instruments.

Board of Directors

The board of directors has the ultimate responsibility for the level of risk taken by the institution. Accordingly, the board should approve overall business strategies and significant policies that govern risk-taking, including those involving securities and derivative contracts. In particular, the board should approve policies identifying managerial oversight and articulating risk tolerances and exposure limits for securities and derivative activities. The board should also actively monitor the performance and risk profile of the institution and its various securities and derivative portfolios. Directors should periodically review information that is sufficiently detailed and timely to allow them to understand and assess the credit, market, and liquidity risks facing the institution as a whole and its securities and derivative positions in particular. These reviews should be conducted at least quarterly and more frequently when the institution holds significant positions in complex instruments. In addition, the board should periodically reevaluate the institution's business strategies and significant risk-management policies and procedures, placing special emphasis on the institution's financial objectives and risk tolerances. The minutes of board meetings and accompanying reports and presentation materials should clearly demonstrate the board's fulfillment of these basic responsibilities. The section of this guidance on managing specific risks provides guidance on the types of objectives, risk tolerances, limits, and reports that directors should consider.

The board of directors should also conduct and encourage discussions between its members and senior management, as well as between senior management and others in the institution, on the institution's risk-management process and risk exposures. Although it is not essential for board members to have detailed technical knowledge of these activities, if they do not, it is their responsibility to ensure that they have adequate access to independent legal and professional advice on the institution's securities and derivative holdings and strategies. The familiarity, technical knowledge, and awareness of directors and senior management should be commensurate with the level and nature of an institution's securities and derivative positions. Accordingly, the board should be knowledgeable enough or have access to independent advice to evaluate recommendations presented by management or investment advisors.

Senior Management

Senior management is responsible for ensuring that there are adequate policies and procedures for conducting investment and end-user activities on both a long-range and day-to-day basis. Management should maintain clear lines of authority and responsibility for acquiring instruments and managing risk, setting appropriate limits on risk-taking, establishing adequate systems for measuring risk, setting acceptable standards for valuing positions and measuring performance, establishing effective internal controls, and enacting a comprehensive risk-reporting and risk-management review process. To provide adequate oversight, management should fully understand the institution's risk profile, including that of its securities and derivative activities. Examiners should review the reports to senior management and evaluate whether they provide both good summary information and sufficient detail to enable management to assess the sensitivity of securities and derivative holdings to changes in credit quality, market prices and rates, liquidity conditions, and other important risk factors. As part of its oversight responsibilities, senior management should periodically review the organization's risk-management procedures to ensure that they remain appropriate and sound. Senior management should also encourage and participate in active discussions with members of the board and with risk-management staff regarding risk measurement, reporting, and management procedures.

Management should ensure that investment and end-user activities are conducted by competent staff whose technical knowledge and experience is consistent with the nature and scope of the institution's activities. There should be sufficient depth in staff resources to manage these activities if key personnel are not available. Management should also ensure that back-office and financial-control resources are sufficient to manage and control risks effectively.

Independence in Managing Risks

The process of measuring, monitoring, and controlling risks within an institution should be managed as independently as possible from those individuals who have the authority to initiate transactions. Otherwise, conflicts of interest could develop. The nature and extent of this independence should be commensurate with the size and complexity of an institution's securities and derivative activities. Institutions with large and complex balance sheets or with significant holdings of complex instruments would be expected to have risk managers or risk-management functions fully independent of the individuals who have the authority to conduct transactions. Institutions with less complex holdings should ensure that there is some mechanism for independently reviewing both the level of risk exposures created by securities and derivative holdings and the adequacy of the process used in managing those exposures. Depending on the size and nature of the institution, this review function may be carried out by either management or a board committee. Regardless of size and sophistication, institutions should ensure that back-office, settlement, and transaction-reconciliation responsibilities are conducted and managed by personnel who are independent of those initiating risk-taking positions.

Policies, Procedures, and Limits

Institutions should maintain written policies and procedures that clearly outline their approach for managing securities and derivative instruments. These policies should be consistent with the organization's broader business strategies, capital adequacy, technical expertise, and general willingness to take risks. They should identify relevant objectives, constraints, and guidelines for both acquiring instruments and managing portfolios. In doing so, policies should establish a logical framework for limiting the various risks involved in an institution's securities and derivative holdings. Policies should clearly delineate lines of responsibility and authority over securities and derivative activities. They should also provide for the systematic review of products new to the firm. Examiners should evaluate the adequacy of an institution's risk-management policies and procedures in relation to its size, its sophistication, and the scope of its activities.

Specifying Objectives

Institutions can use securities and derivative instruments for several primary and complementary purposes.[3] Banking organizations should articulate these objectives clearly and identify the types of securities and derivative contracts to be used for achieving them. Objectives also should be identified at the appropriate portfolio and institutional levels. These objectives should guide the acquisition of individual instruments

3. Such purposes include, but are not limited to, generating earnings, creating funding opportunities, providing liquidity, hedging risk exposures, taking risk positions, modifying and managing risk profiles, managing tax liabilities, and meeting pledging requirements.

and provide benchmarks for periodically evaluating the performance and effectiveness of an institution's holdings, strategies, and programs. Whenever multiple objectives are involved, management should identify the hierarchy of potentially conflicting objectives.

Identifying Constraints, Guidelines, and Limits

An institution's policies should clearly articulate the organization's risk tolerance by identifying its willingness to take the credit, market, and liquidity risks involved in holding securities and derivative contracts. A statement of authorized instruments and activities is an important vehicle for communicating these risk tolerances. This statement should clearly identify permissible instruments or instrument types and the purposes or objectives for which the institution may use them. The statement also should identify permissible credit quality, market-risk sensitivity, and liquidity characteristics of the instruments and portfolios used in nontrading activities. For example, in the case of market risk, policies should address the permissible degree of price sensitivity and/or effective maturity volatility, taking into account an instrument's or portfolio's option and leverage characteristics. Specifications of permissible risk characteristics should be consistent with the institution's overall credit-, market-, and liquidity-risk limits and constraints, and should help delineate a clear set of institutional limits for use in acquiring specific instruments and managing portfolios. Limits can be specified either as guidelines within the overall policies or in management operating procedures. Further guidance on managing specific risks and on the types of constraints and limits an institution might use in managing the credit, market, and liquidity risk of securities and derivative contracts is provided later in this section.

Limits should be set to guide acquisition and ongoing management decisions, control exposures, and initiate discussion within the organization about apparent opportunities and risks. Although procedures for establishing limits and operating within them may vary among institutions, examiners should determine whether the organization enforces its policies and procedures through a clearly identified system of risk limits. The organization's policies should also include specific guidance on the resolution of limit excesses. Positions that exceed established limits should receive the prompt attention of appropriate management and should be resolved according to approved policies.

Limits should implement the overall risk tolerances and constraints articulated in general policy statements. Depending on the nature of an institution's holdings and its general sophistication, limits can be identified for individual business units, portfolios, instrument types, or specific instruments. The level of detail of risk limits should reflect the characteristics of the institution's holdings, including the types of risk to which the institution is exposed. Regardless of their specific form or level of aggregation, limits should be consistent with the institution's overall approach to managing various types of risks. They should also be integrated to the fullest extent possible with institution-wide limits on the same risks as they arise in other activities of the firm. Later in this section, specific examiner considerations for evaluating the policies and limits used in managing each of the various types of risks involved in nontrading securities and derivative activities are addressed.

New-Product Review

An institution's policies should also provide for effective review of any products being considered that would be new to the firm. An institution should not acquire a meaningful position in a new instrument until senior management and all relevant personnel (including those in internal-control, legal, accounting, and auditing functions) understand the product and can integrate it into the institution's risk-measurement and control systems. An institution's policies should define the terms "new product" and "meaningful position" consistent with its size, complexity, and sophistication. Institutions should not be hesitant to define an instrument as a new product. Small changes in the payment formulas or other terms of relatively simple and standard products can greatly alter their risk profiles and justify designation as a new product. New-product reviews should analyze all of the relevant risks involved in an instrument and assess how well the product or activity achieves specified objectives. New-product reviews also should include a description of the relevant accounting guidelines and identify the procedures for measuring, monitoring, and controlling the risks involved.

Accounting Guidelines

The accounting systems and procedures used for general-purpose financial statements and regulatory reporting purposes are critically important to enhancing the transparency of an institution's risk profile. Accordingly, an institution's policies should provide clear guidelines on accounting for all securities and derivative holdings. Accounting treatment should be consistent with specified objectives and with the institution's regulatory requirements. Furthermore, institutions should ensure that they designate each cash or derivative contract for accounting purposes consistent with appropriate accounting policies and requirements. Accounting for nontrading securities and OBS derivative contracts should reflect the economic substance of the transactions. When instruments are used for hedging purposes, the hedging rationale and performance criteria should be well documented. Management should reassess these designations periodically to ensure that they remain appropriate.

Risk-Measurement and Reporting Systems

Clear procedures for measuring and monitoring risks are the foundation of a sound risk-management process. Examiners should ensure that an institution sufficiently integrates these functions into its ongoing management process and that relevant personnel recognize their role and understand the instruments held.

Risk Measurement

An institution's system for measuring the credit, market, liquidity, and other risks involved in cash and derivative contracts should be as comprehensive and accurate as practicable. The degree of comprehensiveness should be commensurate with the nature of the institution's holdings and risk exposures. Exposures to each type of risk (that is, credit, market, liquidity) should be aggregated across securities and derivative contracts and integrated with similar exposures arising from lending and other business activities to obtain the institution's overall risk profile.

Examiners should evaluate whether the risk measures and the risk-measurement process are sufficient to accurately reflect the different types of risks facing the institution. Institutions should establish clear risk-measurement standards for both the acquisition and ongoing management of securities and derivative positions. Risk-measurement standards should provide a common framework for limiting and monitoring risks and should be understood by relevant personnel at all levels of the institution—from individual managers to the board of directors.

Acquisition standards. Institutions conducting securities and derivative activities should have the capacity to evaluate the risks of instruments before acquiring them. Before executing any transaction, an institution should evaluate the instrument to ensure that it meets the various objectives, risk tolerances, and guidelines identified by the institution's policies. Evaluations of the credit-, market-, and liquidity-risk exposures should be clearly and adequately documented for each acquisition. Documentation should be appropriate for the nature and type of instrument; relatively simple instruments would probably require less documentation than instruments with significant leverage or option characteristics.

Institutions with significant securities and derivative activities are expected either to conduct in-house preacquisition analyses or use specific third-party analyses that are independent of the seller or counterparty. Analyses provided by the originating dealer or counterparty should be used only when a clearly defined investment advisory relationship exists. Less active institutions with relatively uncomplicated holdings may use risk analyses provided by the dealer only if the analyses are derived using standard industry calculators and market conventions. Such analyses must comprehensively depict the potential risks involved in the acquisition, and they should be accompanied by documentation that sufficiently demonstrates that the acquirer understands fully both the analyses and the nature of the institution's relationship with the provider of these analyses. Notwithstanding information and analyses obtained from outside sources, management is ultimately responsible for understanding the nature and risk profiles of the institution's securities and derivative holdings.

When reviewing an instrument, it is a prudent practice for institutions to obtain and compare price quotes and risk analyses from more than one dealer before acquisition. Institutions should ensure that they clearly understand the responsibilities of any outside parties that provide analyses and price quotes. If analyses and price quotes provided by dealers are used, institutions should assume that each party deals at arm's length for its own account unless a written agreement stating otherwise exists. Institutions should exercise caution when dealers limit the institution's ability to show securities or derivative contract proposals to other dealers to receive comparative price quotes or risk analyses. As a general sound practice, unless the dealer or counterparty is also acting under a specific investment advisory relationship, an investor or end-user should not acquire an instrument or enter into a transaction if its fair value or the analyses required to assess its risk cannot be determined through a means that is independent of the originating dealer or counterparty.

Portfolio-management standards. Institutions should periodically review the performance and effectiveness of instruments, portfolios, and institutional programs and strategies. This review should be conducted at least quarterly and should evaluate the extent to which the institution's securities and derivative holdings meet the various objectives, risk tolerances, and guidelines established by the institution's policies.[4] Institutions with large or highly complex holdings should conduct reviews more frequently.

For internal measurements of risk, effective measurement of the credit, market, and liquidity risks of many securities and derivative contracts requires mark-to-market valuations. Accordingly, the periodic revaluation of securities and derivative holdings is an integral part of an effective risk-measurement system. Periodic revaluations should be fully documented. When available, actual market prices should be used. For less liquid or complex instruments, institutions with only limited holdings may use properly documented periodic prices and analyses provided by dealers or counterparties. More active institutions should conduct periodic revaluations and portfolio analyses using either in-house capabilities or outside-party analytical systems that are independent of sellers or counterparties. Institutions should recognize that indicative price quotes and model revaluations may differ from the values at which transactions can be executed.

Stress testing. Analyzing the credit, market, and liquidity risk of individual instruments, portfolios, and the entire institution under a variety of unusual and stressful conditions is an important aspect of the risk-measurement process. Management should seek to identify the types of situations, or the combinations of credit and market events, that could produce substantial losses or liquidity problems. Typically, management considers the institutions's consolidated exposures when managing nontrading securities and derivative contracts; therefore, the effect of stress on these exposures should be reviewed. Stress tests should evaluate changes in market conditions, including alternatives in the underlying assumptions used to value instruments. All major assumptions used in stress tests should be identified.

Stress tests should not be limited to quantitative exercises that compute potential losses or gains, but should include qualitative analyses of the tools available to management to deal with various scenarios. Contingency plans outlining operating procedures and lines of communication, both formal and informal, are important products of such qualitative analyses.

The appropriate extent and sophistication of an institution's stress testing depend heavily on the scope and nature of its securities and derivative holdings and on its ability to limit the effect of adverse events. Institutions holding securities or derivative contracts with complex credit, market, or liquidity risk profiles should have an established regime of stress testing. Examiners should consider the circumstances at each institution when evaluating the adequacy or need for stress-testing procedures.

Risk Reporting

An accurate, informative, and timely management information system is essential. Examiners should evaluate the adequacy of an institution's monitoring and reporting of the risks, returns,

4. For example, the performance of instruments and portfolios used to meet objectives for tax-advantaged earnings should be evaluated to ensure that they meet the necessary credit-rating, market-sensitivity, and liquidity characteristics established for this objective.

and overall performance of security and derivative activities to senior management and the board of directors. Management reports should be frequent enough to provide the responsible individuals with adequate information to judge the changing nature of the institution's risk profile and to evaluate compliance with stated policy objectives and constraints.

Management reports should translate measured risks from technical and quantitative formats to formats that can be easily read and understood by senior managers and directors, who may not have specialized and technical knowledge of all financial instruments used by the institution. Institutions should ensure that they use a common conceptual framework for measuring and limiting risks in reports to senior managers and directors. These reports should include the periodic assessment of the performance of appropriate instruments or portfolios in meeting their stated objective, subject to the relevant constraints and risk tolerances.

Management Evaluation and Review

Management should regularly review the institution's approach and process for managing risks. This includes regularly assessing the methodologies, models, and assumptions used to measure risks and limit exposures. Proper documentation of the elements used in measuring risks is essential for conducting meaningful reviews. Limits should be compared with actual exposures. Reviews should also consider whether existing measures of exposure and limits are appropriate in view of the institution's holdings, past performance, and current capital position.

The frequency of the reviews should reflect the nature of an institution's holdings and the pace of market innovations in measuring and managing risks. At a minimum, institutions with significant activities in complex cash or derivative contracts should review the underlying methodologies of the models they use at least annually—and more often as market conditions dictate—to ensure that they are appropriate and consistent. Reviews by external auditors or other qualified outside parties, such as consultants with expertise in highly technical models and risk-management techniques, may often supplement these internal evaluations. Institutions depending on outside parties to provide various risk-measurement capabilities should ensure that the outside institution has personnel with the necessary expertise to identify and evaluate the important assumptions incorporated in the risk-measurement methodologies it uses.

Comprehensive Internal Controls and Audit Procedures

Institutions should have adequate internal controls to ensure the integrity of the management process used in investment and end-user activities. Internal controls consist of procedures, approval processes, reconciliations, reviews, and other mechanisms designed to provide a reasonable assurance that the institution's risk-management objectives for these activities are achieved. Appropriate internal controls should address all of the various elements of the risk-management process, including adherence to polices and procedures, the adequacy of risk identification, and risk measurement and reporting.

An important element of a bank's internal controls for investment and end-user activities is comprehensive evaluation and review by management. Management should ensure that the various components of the bank's risk-management process are regularly reviewed and evaluated by individuals who are independent of the function they are assigned to review. Although procedures for establishing limits and for operating within them may vary among banks, management should conduct periodic reviews to determine whether the organization complies with its investment and end-user risk-management policies and procedures. Positions that exceed established limits should receive the prompt attention of appropriate management and should be resolved according to the process described in approved policies. Periodic reviews of the risk-management process should also address any significant changes in the nature of instruments acquired, limits, and internal controls that have occurred since the last review.

Examiners should also review the internal controls of all key activities involving securities and derivative contracts. For example, for transaction recording and processing, examiners should evaluate and assess adherence to the written policies and procedures for recording transactions. They should also analyze the transaction-processing cycle to ensure the integrity and accuracy of the institution's records and management reports. Examiners should review all significant internal controls associated with the management of the credit, market, liquidity, operational, and legal risks involved in securities and derivative holdings.

The examiner should review the frequency, scope, and findings of any independent internal and external auditors relative to the institution's securities and derivative activities. When applicable, internal auditors should audit and test the risk-management process and internal controls periodically. Internal auditors are expected to have a strong understanding of the specific products and risks faced by the organization. In addition, they should have sufficient expertise to evaluate the risks and controls of the institution. The depth and frequency of internal audits should increase if weaknesses and significant issues exist or if portfolio structures, modeling methodologies, or the overall risk profile of the institution has changed.

In reviewing risk management of nontrading securities and derivative activities, internal auditors should thoroughly evaluate the effectiveness of the internal controls used for measuring, reporting, and limiting risks. Internal auditors should also evaluate compliance with risk limits and the reliability and timeliness of information reported to the institution's senior management and board of directors, as well as the independence and overall effectiveness of the institution's risk-management process. The level of confidence that examiners place in an institution's audit programs, the nature of the audit findings, and management's response to those findings will influence the scope of the current examination of securities and derivative activities.

Examiners should pay special attention to significant changes in the nature of instruments acquired, risk-measurement methodologies, limits, and internal controls that have occurred since the last examination. Significant changes in earnings from securities and derivative contracts, in the size of positions, or in the value-at-risk associated with these activities should also receive attention during the examination.

Evaluating Management of Specific Risks

Specific considerations in evaluating the key elements of sound risk-management systems as they relate to the credit, market, liquidity, operating, and legal risks involved in securities and derivative contracts for nontrading activities are described below.

Credit Risk

Broadly defined, credit risk is the risk that an issuer or counterparty will fail to perform on an obligation to the institution. The policies of an institution should recognize credit risk as a significant risk posed by the institution's securities and derivative activities. Accordingly, policies should identify credit-risk constraints, risk tolerances, and limits at the appropriate instrument, portfolio, and institutional levels. In doing so, institutions should ensure that credit-risk constraints are clearly associated with specified objectives. For example, credit-risk constraints and guidelines should be defined for instruments used to meet pledging requirements, generate tax-advantaged income, hedge positions, generate temporary income, or meet any other specifically defined objective.

As a matter of general policy, an institution should not acquire securities or derivative contracts until it has assessed the creditworthiness of the issuer or counterparty and determined that the risk exposure conforms with its policies. The credit risk arising from these positions should be incorporated into the overall credit-risk profile of the institution to the fullest extent possible. Given the interconnectedness of the various risks facing the institution, organizations should also evaluate the effect of changes in issuer or counterparty credit standing on an instrument's market and liquidity risk. As a matter of policy, the board of directors and responsible senior management should be informed of the institution's total credit-risk exposures at least quarterly.

Selection of securities dealers. In managing their credit risk, institutions also should consider settlement and presettlement credit risk. The selection of dealers, investment bankers, and brokers is particularly important in managing these risks effectively. An institution's policies should identify criteria for selecting these organizations and list all approved firms. The approval process should include a review of each firm's financial statements and an evaluation of its ability to honor its commitments. An inquiry into the general reputation of the dealer is also appropriate. The board of directors or a committee thereof should set limits on the amounts and types of transactions authorized for each firm. They should also periodically review and reconfirm the list of authorized dealers, investment bankers, and brokers.

The management of a depository institution should have sufficient knowledge about the securities firms and personnel with whom they are doing business. A depository institution should not engage in securities transactions with any securities firm that is unwilling to provide complete and timely disclosure of its financial condition. Management should review the securities firm's financial statements and evaluate the firm's ability to honor its commitments both before entering into transactions with the firm and periodically thereafter. An inquiry into the general reputation of the dealer also is necessary. The board of directors or an appropriate committee of the board should periodically review and approve a list of securities firms with whom management is authorized to do business. The board or an appropriate committee thereof should also periodically review and approve limits on the amounts and types of transactions to be executed with each authorized securities firm. Limits to be considered should include dollar amounts of unsettled trades, safekeeping arrangements, repurchase transactions, securities lending and borrowing, other transactions with credit risk, and total credit risk with an individual dealer.

At a minimum, depository institutions should consider the following in selecting and retaining a securities firm:

- the ability of the securities dealer and its subsidiaries or affiliates to fulfill commitments as evidenced by their capital strength, liquidity, and operating results (This evidence should be gathered from current financial data, annual reports, credit reports, and other sources of financial information.)
- the dealer's general reputation or financial stability and its fair and honest dealings with customers (Other depository institutions that have been or are currently customers of the dealer should be contacted.)
- information available from state or federal securities regulators and securities industry self-regulatory organizations, such as the National Association of Securities Dealers, concerning any formal enforcement actions against the dealer, its affiliates, or associated personnel
- in those instances when the institution relies on the advice of a dealer's sales representative, the experience and expertise of the sales representative with whom business will be conducted

In addition, the board of directors (or an appropriate committee of the board) must ensure that the depository institution's management has established appropriate procedures to obtain and maintain possession or control of securities purchased. Purchased securities and repurchase-agreement collateral should only be left in safekeeping with selling dealers when (1) the board of directors or an appropriate committee thereof is completely satisfied as to the creditworthiness of the securities dealer and (2) the aggregate market value of securities held in safekeeping is within credit limitations that have been approved by the board of directors (or an appropriate committee of the board) for unsecured transactions (see the October 1985 FFIEC policy statement ''Repurchase Agreements of Depository Institutions with Securities Dealers and Others'').

State lending limits generally do not extend to the safekeeping arrangements described above. Notwithstanding this general principle, a bank's board of directors should establish prudent limits for safekeeping arrangements. These prudential limits generally involve a fiduciary relationship, which presents operational rather than credit risks.

To avoid concentrations of assets or other types of risk, banking organizations should, to the extent possible, try to diversify the firms they use for safekeeping arrangements. Further, while certain transactions with securities dealers and safekeeping custodians may entail only operational risks, other transactions with these parties may involve credit risk that could, under some limited circumstances, be subject to statutory lending limits, depending on applicable state laws. If certain transactions are deemed subject to a state's legal lending limit statute because of a particular safekeeping arrangement, the provisions of the state's statutes would, of course, control the extent to which the safekeeping arrangement complies with an individual state's legal lending limit.

Limits. An institution's credit policies should also include guidelines on the quality and quantity of each type of security that may be held. Policies should provide credit-risk diversification and concentration limits, which may define concentrations to a single or related issuer or counterparty, in a geographical area, or in obligations with similar characteristics. Policies should also include procedures, such as increased monitoring and stop-loss limits, for addressing deterioration in credit quality.

Sound credit-risk management requires that credit limits be developed by personnel who are independent of the acquisition function. In authorizing issuer and counterparty credit lines, these personnel should use standards that are consistent with those used for other activities conducted within the institution and with the organization's overall policies and consolidated exposures. To assess the creditworthiness of other organizations, institutions should not rely solely on outside sources, such as standardized ratings provided by independent rating agencies, but should perform their own analysis of a counterparty's or issuer's financial strength. In addition, examiners should review the credit-approval process to ensure that the credit risks of specific products are adequately identified and that credit-approval procedures are followed for all transactions.

For most cash instruments, credit exposure is measured as the current carrying value. In the case of many derivative contracts, especially those traded in OTC markets, credit exposure is measured as the replacement cost of the position, plus an estimate of the institution's potential future exposure to changes in the replacement value of that position in response to market price changes. Replacement costs of derivative contracts should be determined using current market prices or generally accepted approaches for estimating the present value of future payments required under each contract, at current market rates.

The measurement of potential future credit-risk exposure for derivative contracts is more subjective than the measurement of current exposure and is primarily a function of the time remaining to maturity; the number of exchanges of principal; and the expected volatility of the price, rate, or index underlying the contract. Potential future exposure can be measured using an institution's own simulations or, more simply, by using add-ons such as those included in the Federal Reserve's risk-based capital guidelines. Regardless of the method an institution uses, examiners should evaluate the reasonableness of the assumptions underlying the institution's risk measure.

For derivative contracts and certain types of cash transactions, master agreements (including netting agreements) and various credit enhancements (such as collateral or third-party guarantees) can reduce settlement, issuer, and counterparty credit risk. In such cases, an institution's credit exposures should reflect these risk-reducing features only to the extent that the agreements and recourse provisions are legally enforceable in all relevant jurisdictions. This legal enforceability should extend to any insolvency proceedings of the counterparty. Institutions should be prepared to demonstrate sufficient due diligence in evaluating the enforceability of these contracts.

In reviewing credit exposures, examiners should consider the extent to which positions exceed credit limits and whether exceptions are resolved according to the institution's adopted policies and procedures. Examiners should also evaluate whether the institution's reports adequately provide all personnel involved in the acquisition and management of financial instruments with relevant, accurate, and timely information about the credit exposures and approved credit lines.

Market Risk

Market risk is the exposure of an institution's financial condition to adverse movements in the market rates or prices of its holdings before such holdings can be liquidated or expeditiously offset. It is measured by assessing the effect of changing rates or prices on either the earnings or economic value of an individual instrument, a portfolio, or the entire institution. Although many banking institutions focus on carrying values and reported earnings when assessing market risk at the institutional level, other measures focusing on total returns and changes in economic or fair values better reflect the potential market-risk exposure of institutions, portfolios, and individual instruments. Changes in fair values and total returns directly measure the effect of market movements on the economic value of an institution's capital and provide significant insights into their ultimate effects on the institution's long-term earnings. Institutions should manage and control their market risks using both an earnings and an economic-value approach, and at least on an economic or fair-value basis.

When evaluating capital adequacy, examiners should consider the effect of changes in market rates and prices on the economic value of the institution by evaluating any unrealized losses in an institution's securities or derivative positions. This evaluation should assess the ability of the institution to hold its positions and function as a going concern if recognition of unrealized losses would significantly affect the institution's capital ratios. Examiners also should consider the impact that liquidating positions with unrealized losses may have on the institution's prompt-corrective-action capital category.

Market-risk limits should be established for both the acquisition and ongoing management of an institution's securities and derivative holdings and, as appropriate, should address exposures for individual instruments, instrument types, and portfolios. These limits should be integrated fully with limits established for the entire institution. At the institutional level, the board of directors should approve market-risk exposure limits that specify percentage changes in the economic value of capital and, when applicable, in the projected earnings of the institution under various market scenarios. Similar and complementary limits on the volatility of prices or fair value should be established at the appropriate instrument, product-type, and portfolio levels, based on the institution's willingness to accept market risk. Limits on the variability of effective maturities may also be desirable for certain types of instruments or portfolios.

The scenarios an institution specifies for assessing the market risk of its securities and derivative products should be sufficiently rigorous to capture all meaningful effects of any options. For example, in assessing interest-rate risk, scenarios such as 100, 200, and 300 basis point parallel shifts in yield curves should be considered as well as appropriate nonparallel shifts in structure to evaluate potential basis, volatility, and yield curve risks.

Accurately measuring an institution's market risk requires timely information about the current carrying and market values of its securities and derivative holdings. Accordingly, institutions should have market-risk measurement systems commensurate with the size and nature of these holdings. Institutions with significant holdings of highly complex instruments should ensure that they have independent means to value their positions. Institutions using internal models to measure risk should have adequate procedures to validate the models and periodically review all elements of the modeling process, including its assumptions and risk-measurement techniques. Institutions relying on third parties for market-risk measurement systems and analyses should fully understand the assumptions and techniques used by the third party.

Institutions should evaluate the market-risk exposures of their securities and derivative positions and report this information to their boards of directors regularly, not less frequently than each quarter. These evaluations should assess trends in aggregate market-risk exposure and the performance of portfolios relative to their established objectives and risk constraints. They also should identify compliance with board-approved limits and identify any exceptions to established standards. Examiners should ensure that institutions have mechanisms to detect and adequately address exceptions to limits and guidelines. Examiners should also determine that management reporting on market risk appropriately addresses potential exposures to basis risk, yield curve changes, and other factors pertinent to the institution's holdings. In this connection, examiners should assess an institution's compliance with broader guidance for managing interest-rate risk in a consolidated organization.

Complex and illiquid instruments often involve greater market risk than broadly traded, more liquid securities. Often, this higher potential market risk arising from illiquidity is not captured by standardized financial-modeling techniques. This type of risk is particularly acute for instruments that are highly leveraged or that are designed to benefit from specific, narrowly defined market shifts. If market prices or rates do not move as expected, the demand for these instruments can evaporate. When examiners encounter such instruments, they should review how adequately the institution has assessed its potential market risks. If the risks from these instruments are material, the institution should have a well-documented process for stress testing their value and liquidity assumptions under a variety of market scenarios.

Liquidity Risk

Banks face two types of liquidity risk in their securities and derivative activities: risks related to specific products or markets and risks related to the general funding of their activities. The former, market-liquidity risk, is the risk that an institution cannot easily unwind or offset a particular position at or near the previous market price because of inadequate market depth or disruptions in the marketplace. The latter, funding-liquidity risk, is the risk that the bank will be unable to meet its payment obligations on settlement dates. Since neither type of liquidity risk is unique to securities and derivative activities, management should evaluate these risks in the broader context of the institution's overall liquidity.

When specifying permissible securities and derivative instruments to accomplish established objectives, institutions should take into account the size, depth, and liquidity of the markets for specific instruments, and the effect these characteristics may have on achieving an objective. The market liquidity of certain types of instruments may make them entirely inappropriate for achieving certain objectives. Moreover, institutions should consider the effects that market risk can have on the liquidity of different types of instruments. For example, some government-agency securities may have embedded options that make them highly illiquid during periods of market volatility and stress, despite their high credit rating. Accordingly, institutions should clearly articulate the market-liquidity characteristics of instruments to be used in accomplishing institutional objectives.

The funding risk of an institution becomes a more important consideration when its unrealized losses are material; therefore, this risk should be a factor in evaluating capital adequacy. Institutions with weak liquidity positions are more likely to be forced to recognize these losses and suffer declines in their accounting and regulatory capital. In extreme cases, these effects could force supervisors to take prompt corrective actions.

Examiners should assess whether the institution adequately considers the potential liquidity risks associated with the liquidation of securities or the early termination of derivative contracts. Many forms of standardized contracts for derivative transactions allow counterparties to request collateral or terminate their contracts early if the institution experiences an adverse credit event or a deterioration in its financial condition. In addition, under situations of market stress, customers may ask for the early termination of some contracts within the context of the dealer's market-making activities. In these circumstances, an institution that owes money on derivative transactions may be required to deliver collateral or settle a contract early, possibly at a time when the institution may face other funding and liquidity pressures. Early terminations may also open additional, unintended market positions. Management and directors should be aware of these potential liquidity risks and address them in the institution's liquidity plan and in the broader context of the institution's liquidity-management process. In their reviews, examiners should consider the extent to which such potential obligations could present liquidity risks to the institution.

Operating and Legal Risks

Operating risk is the risk that deficiencies in information systems or internal controls will result in unexpected loss. Some specific sources of operating risk include inadequate procedures, human error, system failure, or fraud. Inaccurately assessing or controlling operating risks is one of the more likely sources of problems facing institutions involved in securities and derivative activities.

Adequate internal controls are the first line of defense in controlling the operating risks involved in an institution's securities and derivative activities. Of particular importance are internal controls to ensure that persons executing transactions are separated from those individuals responsible for processing contracts, confirming transactions, controlling various clearing accounts, approving the accounting methodology or entries, and performing revaluations.

Institutions should have approved policies, consistent with legal requirements and internal policies, that specify documentation requirements for transactions and formal procedures for saving and safeguarding important documents. Relevant personnel should fully understand the requirements. Examiners should also consider the extent to which institutions evaluate and control operating risks through internal audits, stress testing, contingency planning, and other managerial and analytical techniques.

An institution's operating policies should establish appropriate procedures to obtain and maintain possession or control of instruments purchased. Institutions should ensure that transactions consummated orally are confirmed as soon as possible. As noted in earlier this section, banking organizations should, to the extent possible, seek to diversify the firms used for their safekeeping arrangements to avoid concentrations of assets or other types of risk.

Legal risk is the risk that contracts are not legally enforceable or documented correctly. This risk should be limited and managed through policies developed by the institution's legal counsel. At a minimum, guidelines and processes should be in place to ensure the enforceability of counterparty agreements. Examiners should determine whether an institution is adequately evaluating the enforceability of its agreements before individual transactions are consummated. Institutions should also ensure that the counterparty has sufficient authority to enter into the transaction and that the terms of the agreement are legally sound. Institutions should further ascertain that their netting agreements are adequately documented, have been executed properly, and are enforceable in all relevant jurisdictions. Institutions should know relevant tax laws and interpretations governing the use of netting instruments.

An institution's policies should also provide conflict-of-interest guidelines for employees who are directly involved in purchasing securities from and selling securities to securities dealers on behalf of their institution. These guidelines should ensure that all directors, officers, and employees act in the best interest of the institution. The board of directors may wish to adopt policies prohibiting these employees from engaging in personal securities transactions with the same securities firms the institution uses without the specific prior approval of the board. The board of directors may also wish to adopt a policy applicable to directors, officers, and employees that restricts or prohibits them from receiving gifts, gratuities, or travel expenses from approved securities dealer firms and their personnel.

INTERNATIONAL-DIVISION INVESTMENTS

The same types of instruments exist in international banking as in domestic banking. Securities and derivative contracts may be acquired by a bank's international division and overseas branches for its own account, and foreign equity investments may be held by the bank directly or through Edge Act corporations. The investments held by most international divisions are predominately securities issued by various governmental entities of the countries in which the bank's foreign branches are located. These investments are held for a variety of purposes:

- They are required by various local laws.
- They are used to meet foreign reserve requirements.
- They result in reduced tax liabilities.
- They enable the bank to use new or increased re-discount facilities or benefit from greater deposit or lending authorities.
- They are used by the bank as an expression of "goodwill" toward a country.

The examiner should be familiar with the applicable sections of Regulation K (12 CFR 211) governing a member bank's international investment holdings, as well as other regulations discussed in this section. Because of the mandatory investment requirements of some countries, securities held cannot always be as "liquid" and "readily marketable" as required in domestic banking. However, the amount of a bank's "mandatory" holdings will normally be a relatively small amount of its total investments or capital funds.

A bank's international division may also hold securities strictly for investment purposes; these are expected to provide a reasonable rate of return commensurate with safety considerations. As with domestic investment securities, the bank's safety must take precedence, followed by liquidity and marketability. Securities held by international divisions are considered to be liquid if they are readily convertible into cash at their approximate carrying value. They are marketable if they can be sold in a very short time at a price commensurate with yield and quality. Speculation in marginal foreign securities to generate more favorable yields is an unsound banking practice and should be discouraged.

Banks are generally prohibited from investing in stocks. However, a number of exceptions (detailed earlier in this section) are often applicable to the international division. For example, the bank may, under section 24A of the Federal Reserve Act (12 USC 371d), hold stock in overseas corporations that hold title to foreign bank premises. Both stock and other securities holdings as required by various laws of a particular country in which the bank maintains a branch may be permitted, with the permission of the Board, in unlimited amounts under section 211.3 of Regulation K—Foreign Branches of

Member Banks (12 CFR 211). Other sections of Regulation K permit the bank to make equity investments in Edge Act and agreement corporations and in foreign banks, subject to certain limitations.

Standard & Poor's, Moody's, and other publications from U.S. rating-services rate Canadian and other selected foreign securities that are authorized for U.S. commercial bank investment purposes under 12 USC 24(7). However, in many other countries, securities-rating services are limited or nonexistent. When they do exist, the ratings are only indicative and should be supplemented with additional information on legality, credit soundness, marketability, and foreign-exchange and country-risk factors. The opinions of local attorneys are often the best source of determining whether a particular foreign security has the full faith and credit backing of a country's government.

Sufficient analytical data must be provided to the bank's board of directors and senior management so they can make informed judgments about the effectiveness of the international division's investment policy and procedures. The institution's international securities and derivative contracts should be included on all board and senior management reports detailing domestic securities and derivative contracts received. These reports should be timely and sufficiently detailed to allow the board of directors and senior management to understand and assess the credit, market, and liquidity risks facing the institution and its securities and derivative positions.

MORTGAGE-DERIVATIVE PRODUCTS

Some mortgage-derivative products exhibit considerably more price volatility than mortgages or ordinary mortgage pass-through securities. If not managed in a safe and sound manner, these products can expose investors to significant risk of loss. The price volatility of these products is caused in part by the uncertain cash flows that result from changes in the prepayment rates of the underlying mortgages.

Mortgage-derivative products are complex; a high degree of technical expertise is required to understand how their prices and cash flows may behave in various interest-rate and prepayment scenarios. Moreover, the secondary market for some of these products can be relatively thin, making them difficult to liquidate if the need arises. Finally, new variants of these instruments continue to be introduced, whose price performance under varying market and economic conditions has not been tested.

Under the February 10, 1992, supervisory policy statement of the Federal Financial Institutions Examination Council (FFIEC), the banking agencies call for special management of mortgage-derivative products. A general principle underlying this policy is that mortgage-derivative products possessing average life or price volatility in excess of a benchmark fixed-rate 30-year mortgage-backed pass-through security are high-risk mortgage securities and are not suitable investments. All high-risk mortgage securities (defined later in this section) acquired by depository institutions after February 10, 1992, must be carried in the institution's trading account or as assets available for sale. Mortgage-derivative products that do not meet the definition of a high-risk mortgage security at the time of purchase may be reported as held-to-maturity, available-for-sale, or held-for-trading, as appropriate. Institutions must ascertain at least annually whether such products have become high-risk mortgage securities. Purchases of high-risk mortgage securities before February 10, 1992, generally will be reviewed in accordance with previously existing supervisory policies.

Institutions generally should hold mortgage-derivative products that meet the definition of a high-risk mortgage security only to reduce interest-rate risk, in accordance with safe and sound practices. Before taking a position in any high-risk mortgage security, an institution should conduct an analysis to ensure that the position will reduce its overall interest-rate risk. Furthermore, depository institutions that purchase high-risk mortgage securities must demonstrate that they understand and are effectively managing the risks associated with these instruments. First, a depository institution must determine whether a mortgage-derivative product is high risk before purchasing it. A prospectus supplement or other supporting analysis that fully details the cash flows covering each of the securities held by the institution should be obtained and analyzed before purchase and retained for examiner review. In any event, a prospectus supplement should be obtained as soon as it becomes available. Levels of activity involving high-risk mortgage securities should be reasonably related to an institution's capital, capacity to absorb losses, and level of in-house management sophistication and expertise. Appropriate managerial and financial controls must be in place, and the institution must analyze, monitor, and prudently adjust its holdings of high-risk mortgage securities to correspond with changing price and maturity expectations.

An institution should consider the liquidity and price volatility of high-risk mortgage securities before purchasing them. In certain circumstances, the appropriate federal regulatory authority may deem an institution's purchase or retention of high-risk mortgage securities to be contrary to safe and sound practices for depository institutions, which will result in criticism by examiners. Examiners may require the orderly divestiture of high-risk mortgage securities. Securities and other products with risk characteristics similar to those of high-risk mortgage securities, whether carried on or off the balance sheet (such as CMO swaps, but excluding servicing assets), will be subject to the same supervisory treatment as high-risk mortgage securities.

High-Risk Mortgage Securities

In general, any mortgage-derivative product that exhibits greater price volatility than a benchmark fixed-rate 30-year mortgage-backed pass-through security will be deemed to be high risk. For purposes of the FFIEC policy statement, a high-risk mortgage security is defined as any mortgage-derivative product that at the time of purchase, or at a subsequent testing date, meets any of the following tests. (In general, a mortgage-derivative product that does not meet any of the three tests below will be considered to be a non-high-risk mortgage security.)

- *Average-life test.* The mortgage-derivative product has an expected weighted average life greater than 10.0 years.
- *Average-life sensitivity test.* The expected weighted average life of the mortgage-derivative product—
  - — extends by more than 4.0 years, assuming an immediate and sustained parallel shift in the yield curve of plus 300 basis points or
  - — shortens by more than 6.0 years, assuming an immediate and sustained parallel shift in the yield curve of minus 300 basis points.
- *Price-sensitivity test.* The estimated change in the price of the mortgage-derivative product is more than 17 percent, due to an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points.

In applying any of the above tests, all of the underlying assumptions (including prepayment assumptions) for the underlying collateral must be reasonable. All of the assumptions underlying the analysis must be available for examiner review. For example, if an institution's prepayment assumptions differ significantly from the median prepayment assumptions of several major dealers as selected by examiners, the examiners may use these median prepayment assumptions to determine if a particular mortgage-derivative product is high risk. The above tests may be adjusted to consider significant movements in market interest rates, to fairly measure the risk characteristics of new mortgage-backed products, and to take appropriate action to prevent circumvention of the definition of a high-risk mortgage security and other such standards.

Generally, a CMO floating-rate debt class will not be subject to the average-life and average-life sensitivity tests described above if it bears a rate that, at the time of purchase or at a subsequent testing date, is below the contractual cap on the instrument. (An institution may purchase interest-rate contracts that effectively uncap the instrument.) For purposes of this guidance, a CMO floating-rate debt class is a debt class whose rate adjusts at least annually on a one-for-one basis with the debt class's index. The index must be a conventional, widely used market-interest-rate index such as the London Interbank Offered Rate (LIBOR). Inverse floating-rate debt classes are not included in the definition of a floating-rate debt class.

Holdings of High-Risk Mortgage Securities

An institution generally may only acquire a high-risk mortgage-derivative product to reduce its overall interest-rate risk. (Institutions meeting the previously discussed guidance on the use of these securities in a trading account may also purchase these securities for trading purposes.) An institution that has acquired high-risk mortgage securities to reduce interest-rate risk needs to frequently assess its interest-rate risk position and the performance of these securities. Since interest-rate positions constantly change, an institution may determine that its high-risk mortgage securities no longer reduce interest-rate risk. Therefore, mortgage-derivative products that are high risk when acquired shall not be reported as held-to-maturity securities at amortized cost.

In appropriate circumstances, examiners may seek the orderly divestiture of high-risk mortgage securities that do not reduce interest-rate risk. Appropriate circumstances are those in which the examiner determines that continued ownership of high-risk mortgage securities represents an undue safety-and-soundness risk to the institution. This risk can arise from (1) the size of a bank's or thrift's holdings of high-risk mortgage securities in relation to its capital and earnings, (2) management's inability to demonstrate an understanding of the nature of the risks inherent in the securities, (3) the absence of internal monitoring systems and other internal controls to appropriately measure the market and cash-flow risks of these securities, (4) management's inability to prudently manage its overall interest-rate risk, or (5) similar factors.

An institution that owns or plans to acquire high-risk mortgage securities must have a monitoring and reporting system in place to evaluate their expected and actual performance. Institutional analysis must show that the proposed acquisition of a high-risk mortgage security will reduce overall interest-rate risk. After purchase, the institution must evaluate at least quarterly whether the high-risk mortgage security has actually reduced interest-rate risk.

Analyses performed before the purchase of high-risk mortgage securities, and subsequent analyses, must be fully documented and will be subject to examiner review. This review will include an analysis of all management assumptions about the interest-rate risk associated with the institution's assets, liabilities, and off-balance-sheet positions. Analyses performed and records constructed to justify purchases on a post-acquisition basis are unacceptable and will be subject to examiner criticism. Reliance on analyses and documentation obtained from a securities dealer or other outside party without internal analyses by the institution are unacceptable, and reliance on these third-party analyses will be subject to examiner criticism.

Management should also maintain documentation demonstrating it took reasonable steps to ensure that the prices paid for high-risk mortgage securities represented fair market value. Generally, price quotes should be obtained from at least two brokers before executing a trade. If price quotes cannot be obtained from more than one broker, management should document those reasons (such as the unique or proprietary nature of the transaction). In addition, a depository institution that owns high-risk mortgage securities must demonstrate that it has established the following:

- a board-approved portfolio policy that addresses the goals and objectives the institution expects to achieve through its securities activities, including objectives for interest-rate risk reduction with respect to high-risk mortgage securities
- limits on the amounts of funds that may be committed to high-risk mortgage securities
- specific financial-officer responsibility for and authority over securities activities involving high-risk mortgage securities
- adequate information systems
- procedures for periodic evaluation of high-risk mortgage securities and their actual performance in reducing interest-rate risk
- appropriate internal controls

The board of directors or an appropriate committee thereof and the institution's senior management should regularly (at least quarterly) review all high-risk mortgage securities to determine whether they are adequately satisfying the objectives for interest-rate risk reduction set forth in the portfolio policy. The depository institution's senior management should be fully knowledgeable about the risks associated with prepayments and their subsequent impact on its high-risk mortgage securities. Failure to comply with this policy will be viewed as an unsafe and unsound practice.

Non-High-Risk Mortgage Securities

Mortgage-derivative products that do not meet the definition of high-risk mortgage securities at the time of purchase should be reported as held-to-maturity, available-for-sale, or held-for-trading, as appropriate. Institutions must ascertain and document before purchase and at least annually thereafter that non-high-risk mortgage securities that are held to maturity remain outside the high-risk category. If an institution is unable to make these determinations through internal analysis, it must use information derived from a source that is independent of the party from whom the product is being purchased. Standard industry calculators used in the mortgage-related securities marketplace are acceptable and considered independent sources. If relying on this type of independent analysis, institutions are responsible for ensuring that the assumptions underlying the analysis and the resulting calculation are reasonable. Documentation verifying this determination will be subject to examiner review.

A mortgage-derivative product that was not a high-risk mortgage security when it was purchased as an investment may later fall into the high-risk category. When this occurs, the depository institution may continue to designate the mortgage-derivative product as held-to-maturity, providing that management intends and is able to hold the security to maturity. Furthermore, examiners should consider any unrecognized net depreciation in held-to-maturity high-risk securities when the adequacy of the depository institution's capital adequacy is evaluated.

Once a mortgage-derivative product has been designated as high risk, it may be redesignated as nonhigh risk only if, at the end of two consecutive quarters, it does not meet the definition of a high-risk mortgage security. Upon redesignation as a non-high-risk security, it does not need to be tested for another year.

UNSUITABLE INVESTMENT PRACTICES

Institutions should categorize each of their security activities as trading, available-for-sale, or held-to-maturity consistent with GAAP (that is, Statement of Financial Accounting Standards No. 115, ''Accounting for Certain Investments in Debt and Equity Securities,'' as amended) and regulatory reporting standards. Management should reassess the categorizations of its securities periodically to ensure that they remain appropriate.

Securities that are intended to be held principally for the purpose of selling in the near term should be classified as trading assets. Trading activity includes the active and frequent buying and selling of securities for the purpose of generating profits on short-term fluctuations in price. Securities held for trading purposes must be reported at fair value, with unrealized gains and losses recognized in current earnings and regulatory capital. The proper categorization of securities is important to ensure that trading gains and losses are promptly recognized—which will not occur when securities intended to be held for trading purposes are categorized as held-to-maturity or available-for-sale.

It is an unsafe and unsound practice to report securities held for trading purposes as available-for-sale or held-to-maturity securities. A close examination of an institution's actual securities activities will determine whether securities it reported as available-for-sale or held-to-maturity are, in reality, held for trading. When the following securities activities are conducted in available-for-sale or held-to-maturity accounts, they should raise supervisory concerns. The first five practices below are considered trading activities and should not occur in available-for-sale or held-to-maturity securities portfolios, and the sixth practice is wholly unacceptable under all circumstances.

Gains Trading

''Gains trading'' is the purchase of a security and the subsequent sale of that same security at a profit after a short holding period. However, at the same time, securities acquired for this purpose that cannot be sold at a profit are retained in the available-for-sale or held-to-maturity portfolio; unrealized losses on debt securities in these two categories do not directly affect regulatory capital and are not reported in income until the security is sold. Examiners should note institutions that exhibit a pattern or practice of reporting significant amounts of realized gains on sales of nontrading securities (typically, available-for-sale securities) after short holding periods, while continuing to hold other nontrading securities with significant amounts of unrealized losses. In these situations, examiners may designate some or all of the securities reported outside of the trading category as trading assets.

When-Issued Securities Trading

"When-issued" securities trading is the buying and selling of securities in the period between the announcement of an offering and the issuance and payment date of the securities. A purchaser of a when-issued security acquires all of the risks and rewards of owning a security and may sell this security at a profit before having to take delivery and pay for it.

Pair-Offs

"Pair-offs" are security purchases that are closed out or sold at, or before, settlement date. In a pair-off, an institution commits to purchase a security. Then, before the predetermined settlement date, the institution will pair off the purchase with a sale of the same security. Pair-offs are settled net when one party to the transaction remits the difference between the purchase and sale price to the counterparty. Other pair-off transactions may involve the same sequence of events using swaps, options on swaps, forward commitments, options on forward commitments, or other off-balance-sheet derivative contracts.

Extended Settlements

Regular-way settlement for U.S. government and federal-agency securities (except mortgage-backed securities and derivative contracts) is one business day after the trade date. Regular-way settlement for corporate and municipal securities is three business days after the trade date, and settlement for mortgage-backed securities can be up to 60 days or more after the trade date. The use of a settlement period that exceeds the regular-way settlement periods to facilitate speculation is considered a trading activity.

Short Sales

A short sale is the sale of a security that is not owned. Generally, the purpose of a short sale is to speculate on a fall in the price of the security. Short sales should be conducted in the trading portfolio. A short sale that involves the delivery of the security sold short by borrowing it from the depository institution's available-for-sale or held-to-maturity portfolio should not be reported as a short sale. Instead, it should be reported as a sale of the underlying security with gain or loss recognized. Short sales are not permitted for federal credit unions.

Adjusted Trading

Adjusted trading involves the sale of a security to a broker or dealer at a price above the prevailing market value and the simultaneous purchase and booking of a different security, frequently a lower-grade issue or one with a longer maturity, at a price above its market value. Thus, the dealer is reimbursed for its losses on the purchase from the institution and ensured a profit. Adjusted-trading transactions inappropriately defer the recognition of losses on the security sold and establish an excessive reported value for the newly acquired security. Consequently, these transactions are prohibited and may be in violation of 18 USC sections 1001 (False Statements or Entries) and 1005 (False Entries).

ACCOUNTING FOR SECURITIES AND FINANCIAL CONTRACTS

A single class of a financial instrument that can meet trading, investment, or hedging objectives may have a different accounting treatment applied to it, depending on management's purpose for holding it. Therefore, an examiner reviewing investment or trading activities should be familiar with the different accounting methods to ensure that the particular accounting treatment being used is appropriate for the purpose of holding a financial instrument and the economic substance of the related transaction.

The accounting principles that apply to securities portfolios, including trading accounts, and to off-balance-sheet (OBS) derivative instruments are complex and have evolved over time—both with regard to authoritative standards and related banking practices. The objective of this section is to summarize the major aspects of the accounting principles in this important area to make the accounting guidance for both financial reporting and regulatory reporting purposes understandable and useful to examiners and supervisors. Accordingly, it is not intended to set forth new accounting policies for investment activities. While this section provides a summary of important accounting principles for financial reporting and regulatory reporting purposes in this area, it does not list or explain the detailed line items of financial reports that must be reported for securities portfolios or OBS derivative instruments in financial reports. Examiners should consult the sources of generally accepted accounting principles (GAAP) and regulatory reporting requirements that are referred to in this section for more detailed guidance in these areas.

Examiners should be aware that accounting practices in foreign countries may differ from the accounting principles followed in the United States. Nevertheless, foreign institutions are required to submit regulatory reports prepared in accordance with U.S. banking agency regulatory reporting instructions, which to a large extent incorporate GAAP. This section will focus on reporting requirements of the United States.

The major topics covered in this section are listed below. The discussion of specific types of balance-sheet instruments (for example, securities) and OBS derivative instruments (for example, swaps, futures, forwards, and options) is interwoven with the discussion of these topic areas:

- overview of the broad framework for accounting for securities portfolios, including the general framework for trading activities
- general framework for OBS derivative instruments, including hedges
- summaries of specific accounting principles for OBS derivative instruments

Accounting for Securities Portfolios

Treatment under FASB Statement No. 115

In May 1993, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 115, ''Accounting for Certain Investments in Debt and Equity Securities.''[5] FASB 115 supersedes FASB 12, ''Accounting for Certain Marketable Securities,'' and related interpretations. It also amends other standards, including FASB 65, ''Accounting for Certain Mortgage-Banking Activities,'' to eliminate mortgage-backed securities from that statement's scope. FASB 115 addresses investments in equity securities that have readily determinable fair values and all investments in debt securities.[6] The accounting standard is effective for fiscal years beginning after December 15, 1993, for regulatory reporting and financial reporting purposes. It is to be initially applied as of the beginning of an institution's fiscal year and cannot be applied retroactively to prior years' financial statements. Investments subject to the standard are to be classified in three categories and accounted for as follows:

- *Held-to-maturity account*. Debt securities that the institution has the positive intent and ability to hold to maturity are classified as held-to-maturity securities and reported at amortized cost.
- *Trading account*. Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and reported at fair value, with unrealized gains and losses included in earnings. Trading generally reflects active and frequent buying and selling, and trading securities are generally used with the objective of generating profits on short-term differences in price.
- *Available-for-sale account*. Debt and equity securities not classified as either held-to-maturity securities or trading securities areclassified as available-for-sale securities and reported at fair value, with unrealized gains

5. FASB 115 does not apply to investments in equity securities accounted for under the equity method or to investments in consolidated subsidiaries. This statement does not apply to institutions whose specialized accounting practices include accounting for substantially all investments in debt and equity securities at market value or fair value, with changes in value recognized in earnings (income) or in the change in net assets. Examples of those institutions are brokers and dealers in securities, defined-benefit pension plans, and investment companies.

6. FASB 115 states that the fair value of an equity security is readily determinable if sales prices or bid-asked quotations are currently available on a securities exchange registered with the SEC or in the over-the-counter market, provided that those prices or quotations for the over-the-counter market are publicly reported by the National Association of Securities Dealers Automated Quotations systems or by the National Quotation Bureau, Inc. Restricted stock does not meet that definition.

The fair value of an equity security traded only in a foreign market is readily determinable if that foreign market is of a breadth and scope comparable to one of the U.S. markets referred to above. The fair value of an investment in a mutual fund is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions.

and losses excluded from earnings and reported as a net amount in a separate component of shareholders' equity.

Under FASB 115, mortgage-backed securities that are held for sale in conjunction with mortgage-banking activities should be reported at fair value in the trading account and not at LOCOM as originally prescribed by FASB 65. The new standard does not apply to loans, including mortgage loans, that have not been securitized.

Upon the acquisition of a debt or equity security, an institution must place the security into one of the above three categories. At each reporting date, the institution must reassess whether the balance-sheet designation continues to be appropriate. Proper classification of securities is a key examination issue.

FASB 115 recognizes that certain changes in circumstances may cause the institution to change its intent to hold a certain security to maturity without calling into question its intent to hold other debt securities to maturity in the future. Thus, the sale or transfer of a held-to-maturity security due to one of the following changes in circumstances will not be viewed as inconsistent with its original balance-sheet classification:

- evidence of a significant deterioration in the issuer's creditworthiness
- a change in tax law that eliminates or reduces the tax-exempt status of interest on the debt security (but not a change in tax law that revises the marginal tax rates applicable to interest income)
- a major business combination or major disposition (such as the sale of a segment) that necessitates the sale or transfer of held-to-maturity securities to maintain the institution's existing interest-rate risk position or credit risk policy
- a change in statutory or regulatory requirements that significantly modifies either what constitutes a permissible investment or the maximum level of investments in certain kinds of securities, thereby causing an institution to dispose of a held-to-maturity security
- a significant increase by the regulator in the industry's capital requirements that causes the institution to downsize by selling held-to-maturity securities
- a significant increase in the risk weights of debt securities used for regulatory risk-based capital purposes

Furthermore, FASB 115 recognizes that other events that are isolated, nonrecurring, and unusual for the reporting institution and could not have been reasonably anticipated may cause the institution to sell or transfer a held-to-maturity security without necessarily calling into question its intent to hold other debt securities to maturity. However, all sales and transfers of held-to-maturity securities must be disclosed in the footnotes to the financial statements.

An institution must not designate a debt security as held-to-maturity if the institution has the intent to hold the security for only an indefinite period. Consequently, a debt security should not, for example, be designated as held-to-maturity if the banking organization or other company anticipates that the security would be available to be sold in response to—

- changes in market interest rates and related changes in the security's prepayment risk,
- needs for liquidity (for example, due to the withdrawal of deposits, increased demand for loans, surrender of insurance policies, or payment of insurance claims),
- changes in the availability of and the yield on alternative investments,
- changes in funding sources and terms, or
- changes in foreign-currency risk.

According to FASB 115, an institution's asset-liability management may take into consideration the maturity and repricing characteristics of all investments in debt securities, including those held to maturity or available for sale, without tainting or casting doubt on the standard's criterion that there be a ''positive intent to hold until maturity.''[7] However, securities should not be designated as held-to-maturity if they may be sold. Further, liquidity can be derived from the held-to-maturity category by

7. In summary, under FASB 115, sales of debt securities that meet either of the following two conditions may be considered as ''maturities'' for purposes of the balance-sheet classification of securities: (i) The sale of a security occurs near enough to its maturity date (or call date if exercise of the call is probable)—for example, within three months—that interest-rate risk has been substantially eliminated as a pricing factor. (ii) The sale of a security occurs after the institution has already collected at least 85 percent of the principal outstanding at acquisition from either prepayments or scheduled payments.

the use of repurchase agreements that are designated as financings, but not sales.

Transfers of a security between investment categories should be accounted for at fair value. FASB 115 requires that at the date of the transfer, the security's unrealized holding gain or loss must be accounted for as follows:

- For a security transferred from the trading category, the unrealized holding gain or loss at the date of the transfer will have already been recognized in earnings and should not be reversed.
- For a security transferred into the trading category, the unrealized holding gain or loss at the date of the transfer should be recognized in earnings immediately.
- For a debt security transferred into the available-for-sale category from the held-to-maturity category, the unrealized holding gain or loss at the date of the transfer should be recognized in a separate component of shareholders' equity.
- For a debt security transferred into the held-to-maturity category from the available-for-sale category, the unrealized holding gain or loss at the date of the transfer should continue to be reported in a separate component of shareholders' equity, but should be amortized over the remaining life of the security as an adjustment of its yield in a manner consistent with the amortization of any premium or discount.

Transfers from the held-to-maturity category should be rare, except for transfers due to the changes in circumstances that were discussed above. Transfers from the held-to-maturity account not meeting the exceptions indicated above may call into question management's intent to hold other securities to maturity. According to the standard, transfers into or from the trading category should also be rare.

FASB 115 requires that institutions determine whether a decline in fair value below the amortized cost for individual securities in the available-for-sale or held-to-maturity accounts is ''other than temporary'' (that is, whether this decline results from permanent impairment). For example, if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt security that was not impaired at acquisition, an other-than-temporary impairment should be considered to have occurred. If the decline in fair value is judged to be other than temporary, the cost basis of the individual security should be written down to its fair value, and the write-down should be accounted in earnings as a realized loss. This new cost basis should not be written up if there are any subsequent recoveries in fair value.

Other Regulatory Reporting Guidance

As mentioned above, FASB 115 has been adopted for regulatory reporting purposes. In January 1992, the Federal Reserve Board issued a policy statement on securities activities which, among other things, provided supervisory accounting guidance for securities portfolios owned by banks. Elements of this policy statement have been incorporated within this section.

Other supervisory accounting guidance on securities portfolios and related matters is presented in—

- the Federal Reserve Board staff's examination guidelines for asset-securitization activities (specifically, volume 2, which addresses related accounting issues), and
- the call report instructions, particularly, the glossary entries on—
  - — coupon stripping, treasury securities, and STRIPS;
  - — trade fails;
  - — foreign debt–exchange transactions;
  - — market value of securities;
  - — nonaccrual status;
  - — premiums and discounts;
  - — short positions;
  - — sales of assets (see also ''participations in pools of residential mortgages'' for mortgage-backed securities);
  - — trading accounts;
  - — trade-date and settlement-date accounting;[8] and
  - — when-issued securities.

These sources should be reviewed for more detailed guidance in the above areas involving securities portfolios and related transactions.

8. As described in this glossary entry, for call report purposes, the preferred method for reporting securities transactions is recognition on the trade date.

General Framework for OBS Derivative Instruments

As discussed in the previous subsection, the general accounting framework for securities portfolios divides them into three categories: held-to-maturity (accounted for at amortized cost), available-for-sale (accounted for at fair value, with changes in fair value recorded in equity), and trading (accounted for at fair value, with changes in fair value recorded in earnings). On the other hand, the traditional accounting framework (that is, trading, investment, and held-for-sale) continues to be relevant for loans and other assets that are not in the legal form of a security.

In contrast, the general accounting framework for OBS derivative instruments under GAAP is set forth below:

- If the instrument meets certain specified hedge-accounting criteria, the gains or losses (income or expense) associated with the OBS derivative instrument can be deferred and realized on a basis consistent with the income or expense of the item that is being hedged.
- Otherwise, gains or losses must be recognized as they occur, and OBS derivative instruments generally must be marked to market. Of course, any OBS derivative instruments that are used for trading purposes should be placed in a well-supervised trading account and marked to market.

As discussed more fully below, this general framework is derived from FASB 52, ‘‘Foreign-Currency Translation,’’ and FASB 80, ‘‘Accounting for Futures Contracts.’’ Each statement presents different hedging criteria and related guidance. Furthermore, reporting requirements for the call report differ from GAAP with regard to domestic futures and forward contracts and written options. However, the call report follows GAAP for foreign-currency OBS derivative instruments and interest-rate swaps.

It is important to note that while GAAP permits hedge accounting for OBS derivative instruments, both GAAP and the call report prohibit the use of hedge-accounting treatment for securities (sometimes called ‘‘cash-market securities’’) or other on-balance-sheet items that may serve as economic hedges of other balance-sheet or OBS items. Thus, even if a security or other balance-sheet instrument would serve the same purpose as an OBS derivative instrument in effectively hedging an institution’s risk exposures, the gains and losses, or income and expense, on that balance-sheet instrument *cannot* be deferred to a future period when the income or expense on the item being hedged is recognized.

The following addresses important GAAP and call report rules for netting of the assets and liabilities arising from OBS derivative instruments.

SPECIFIC ACCOUNTING PRINCIPLES FOR OBS DERIVATIVE INSTRUMENTS

Instruments Covered by Authoritative Accounting Standards

Futures Contracts Not Associated with Foreign-Currency Exposures (‘‘Domestic Futures Contracts’’)

Futures contracts are firm (legally binding) commitments to purchase or sell a particular financial instrument or index, foreign currency, or commodity at a specified future date, quantity, and price or yield. Futures contracts have standardized contractual terms, are traded on organized exchanges, and are typically settled in cash rather than actual delivery.

Under GAAP, all futures contracts, except for foreign-currency futures contracts, should be reported in accordance with FASB 80, ‘‘Accounting for Futures Contracts.’’ Foreign-currency futures contracts should be reported in accordance with the guidance contained in FASB 52, ‘‘Foreign-Currency Translation.’’ These statements should be referred to for more detailed accounting guidance in these areas.

Treatment of open contracts. Contracts are outstanding (open) until they have been terminated by either the acquisition or delivery of the underlying financial instruments, or by offset. ‘‘Offset’’ is the purchase and sale of an opposite position using an equal number of futures contracts on the same delivery month executed through the same broker or dealer and executed on the same exchange.

Transactions in futures contracts generally involve a deposit of cash as margin, which will generally be reported within ‘‘other assets’’ on the balance sheet. As discussed below, changes in the market values of open positions may affect general ledger accounts and related balance-sheet amounts. However, since open positions are executory contracts (firm commitments) for delivery of the underlying financial instrument, the underlying instrument should not be reflected as an asset or liability on the balance sheet.[9] Only when the closing of an open position results in the acquisition or disposition of the underlying financial instrument would an asset be recorded, or removed from, the balance sheet.

As a prudent management measure, all open positions in futures contracts must be reviewed at least monthly (or more often, if material), and their current market values should be determined using published price quotations. These futures positions must be revalued at their current market value on these valuation dates, and any changes in value should be reported in accordance with the guidance presented below for hedge or non-hedge contracts.

Criteria for hedge-accounting treatment. If certain criteria are met, the accounting under GAAP for a futures contract that is used to hedge an asset, liability, commitment, or anticipated transaction (''hedged item'') should be similar to the method of accounting for the hedged item. This means that changes in the market value of the futures contract are recognized in income when the related changes in the price or interest rate of the hedged item are recognized. Where an anticipated transaction is the hedged item, the change in value of the futures contract is included in the measurement of the anticipated transaction. Realized gains or losses from changes in the market value of futures contracts that qualify as a hedge of an existing asset or liability should be recognized as an adjustment of the carrying amount (often called ''book value'') of the hedged item. A change in the market value of a futures contract that is a hedge of a firm commitment should be included in the measurement of the transaction that satisfies the commitment.

Under FASB 80, a futures contract should be accounted for as a hedge when the following conditions are met:

- The institution must have determined that the item to be hedged (that is, an identifiable asset, liability, firm commitment, or anticipated transaction) will expose it to price or interest-rate risk.
- The futures contract must reduce the exposure to risk. This must be demonstrated at the inception of the hedge by an expectation that changes in the prices of both the contract and the hedged item will be highly correlated. Furthermore, ongoing results must show a high degree of correlation, or the hedge will be considered ineffective and consequently marked to market. In other words, the bank must monitor the price movements of both the hedge contract and the hedged item to determine that it is probable (that is, likely to occur) that the results of the futures contract will offset changes in the market value of the hedged item and that these results have done so from inception to the determination date.
- The futures contract must be designated as a hedge by management at the inception of the hedge.

In order for a futures contract to qualify as a hedge of an anticipated transaction, the following two additional criteria must be met:

- Significant characteristics and expected terms of the anticipated transaction must be identified.
- The occurrence of the anticipated transaction must be probable.[10]

If the criteria for applying hedge-accounting methods have been met, the gain or loss on a futures contract, instead of being currently recognized in income, is an adjustment to the cost of the asset or liability being hedged. The adjustment, then, will be recognized in income when gain or loss on the hedged asset or liability is determined. For example, if the item being hedged is an interest-bearing liability that is reported at amortized cost, the changes in the market value of the futures contract would be reflected as adjustments to the carrying amount (or book value) of the liability. The historical cost of the liability and the adjustments brought about by the hedge would then be amortized in

9. Although the underlying instruments or notional amounts of these commitments are not reported in the balance sheet, they are disclosed in footnotes to the financial statement. For regulatory reporting purposes, open positions in futures contracts are to be reported in the call report, Schedule RC-L.

10. It will be particularly difficult to meet this criteria when an anticipated transaction is not expected to take place in the near future.

interest expense over the expected remaining life of the liability.

If the hedged asset or liability is marked to market, the hedge position will also be marked to market. There is no deferral of gains or losses in this situation; likewise, there is no deferral of gains or losses if the futures contract hedges an anticipated transaction if the asset to be acquired or liability incurred will be reported at fair value.

If a futures contract qualifying as a hedge is closed before the date of the related anticipated transaction, the accumulated change in value of the contract should be carried forward (assuming high correlation has occurred) and included in the measurement of the related transaction. When it becomes probable that the quantity of the anticipated transaction will be less than that originally hedged, a pro rata portion of the futures results that would have been included in the measurement of the transaction should be recognized as a gain or loss.

If high correlation between price changes of the hedged item and the futures position is no longer evident, the bank should discontinue accounting for the futures contracts as a hedge. If this were to occur, the portion of the change in the market value of the contract that has not offset the market-value changes of the hedged item should be reflected in income. The contract should thereafter be accounted for as a nonhedge contract with subsequent changes in the contract's market value reflected in current income. When a futures position that has been an effective hedge is terminated before disposition of the hedged item, the gain or loss on the terminated contracts must be deferred and amortized over the remaining life of the hedged item. If the contacts do not qualify as hedges, the gain or loss is recognized currently in income or expense, as appropriate.

Call report treatment. Regulatory reporting standards, as a general rule, do not permit the deferral of gains or losses by banks on domestic futures and forwards, whether or not the contracts are used for hedging purposes. All changes in market value of futures and forward contracts are reported in income in the period they occur. The banking agencies adopted this reporting standard as a supervisory policy before the issuance of FASB 80. As exceptions to the general prohibition, hedge accounting in accordance with FASB 80 is permitted by the three banking agencies only for futures and forward contracts used to hedge mortgage-banking operations, and those foreign-currency futures contracts that are covered by FASB 52.

Foreign-Currency Off-Balance-Sheet Instruments

The primary source of authoritative guidance for accounting for foreign-currency translations and foreign-currency transactions is FASB 52. The standard encompasses futures contracts, forward agreements, and currency swaps as they relate to foreign-currency hedging.

FASB 52 draws a distinction between foreign-exchange translation and transactions. Translation, generally, focuses on the combining of foreign and domestic entities for presentation in the consolidated financial statements and for reporting these financial statements in one currency. Foreign-currency transactions, in contrast, are transactions (such as purchases or sales) by a business operation in currencies other than its functional currency. For U.S. depository institutions, the functional currency will generally be the dollar for its U.S. operations and will typically be the local currency where its foreign operations transact business.[11]

Foreign-currency translation. Translation is the conversion to U.S. dollars of the financial statement of a foreign operation (branch, division, or subsidiary) that is denominated in the operation's functional currency for inclusion in the parent's consolidated financial statements. The foreign operation's balance sheet is translated at the exchange rate in effect on the statement date, and the income statement is translated at an appropriate weighted-average rate for the reporting period. Gains or losses arising from foreign-currency translation are not recognized currently

11. Detailed guidance of determining the functional currency is set forth in appendix 1 of FASB 52:

"An entity's functional currency is the currency of the primary economic environment in which the entity operates; normally, that is the currency of the environment in which an entity primarily generates and expends cash. The functional currency of an entity is, in principle, a matter of fact. In some cases, the facts will clearly identify the functional currency; in other cases they will not."

FASB 52 indicates the salient economic indicators, and possibly other factors, that should be considered both individually and collectively when determining the functional currency. These factors include cashflow, price and market sales indicators, expense indicators, financing indicators, and intercompany transactions and arrangements.

in income; instead, they are treated as adjustments to a separate component of equity. Recognition in income of these cumulative foreign-currency adjustments will take place when the foreign operation is either sold or substantially liquidated.

An institution may engage in hedging transactions to reduce the risk of exchange losses on translating its net equity investments in foreign operations for presentation in its financial statements, thus avoiding the consequent volatility in its capital position. The effect of the special hedging treatment is to include the change in value of the hedging instrument as a part of the same separate component of equity as the translation adjustment.

Foreign-currency transactions. Gains or losses on foreign-currency transactions, in contrast to translation, are recognized in income as they occur, unless they arise from a qualifying hedge. FASB 52 provides the following guidance about the types of foreign-currency transactions for which gain or loss is not currently recognized in earnings.

Gains and losses on the following foreign-currency transactions should not be included in determining net income but should be reported in the same manner as translation adjustments:

- foreign-currency transactions that are designated as, and are effective as, economic hedges of a net investment in a foreign entity, commencing as of the designation date
- intercompany foreign-currency transactions that are of a long-term-investment nature (that is, settlement is not planned or anticipated in the foreseeable future), when the entities to the transaction are consolidated, combined, or accounted for by the equity method in the reporting institution's financial statements

In addition to hedges of the balance sheet, a gain or loss on a forward contract or other foreign-currency transaction that is intended to hedge an identifiable foreign-currency commitment (for example, a firm commitment to sell or purchase equipment) should be deferred and included in the measurement of the related foreign-currency transaction (as an adjustment to the revenue or cost of the equipment in the example). If a foreign-currency hedge is terminated before the transaction date of the related commitment, any deferred gain or loss is to remain deferred until recognition of gain or loss on the items that were hedged occurs. Losses should not be deferred, however, if it is estimated that deferral would lead to recognizing losses in later periods. A foreign-currency transaction should be considered a hedge of an identifiable foreign-currency commitment if both of the following conditions are met:

- The foreign-currency transaction is designated as, and is effective as, a hedge of a foreign-currency commitment.
- The foreign-currency commitment is firm.

Thus, FASB 52 is distinguished from FASB 80 in that hedging the risks from arrangements that have not matured into a firm commitment (that is, an anticipated transaction), such as forecasted foreign sales, do not qualify for hedge treatment. Another dissimilarity between FASB 52 and 80 is that the hedge of a foreign-currency exposure can be considered in isolation; there is no requirement that the overall risk of the institution must be reduced by the hedge as there is under FASB 80. Under the latter accounting standard, an institution is, in effect, required to consider the presence of any natural hedges that may be present in its balance sheet. To illustrate, an institution with foreign-currency-denominated receivables has foreign-exchange risk; however, any accounts payable that are denominated in the same currency as the receivables reduce the overall exposure. Under FASB 52, however, the institution could hedge the gross amount of receivables and qualify for deferring gain or loss recognition. Note, however, that by neutralizing the exposure from the receivables, the institution now has exchange risk equal to its payables position. Thus, gains or losses from a hedge of a foreign-currency risk may be deferred, even though the hedge position may increase the overall foreign-exchange risk of the institution.

To qualify for deferral, a foreign-currency-hedge position is required to be denominated in the same currency as the items it is hedging, unless such a hedge is impracticable. "Impracticable" means there are severe impediments to using the currency, such as illiquidity or a limited exchange market in the currency that is to be hedged, not merely that it is uneconomical. Since the foreign-exchange-hedge position is generally denominated in the same currency as the items that are being hedged, there will be perfect correlation (that is, no basis risk) between the hedged items and the hedge position. Therefore, ongoing monitoring of the correlation between the foreign-exchange hedge and the hedged items is required only if a substitute or proxy currency is being used.

Instruments That Are Not Covered by Authoritative Accounting Standards

Forward Contracts

Domestic forward contracts, including forward-rate agreements, are generally accounted for by analogy to the accounting guidance for futures contracts set forth in FASB 80, which is summarized above. As noted above, the accounting for foreign-currency-forward contracts is addressed by FASB 52. Forward-rate agreements denominated in a foreign currency are generally accounted for by analogy to the accounting guidance for forward contracts set forth in FASB 52. Of course, any such instruments that are used for trading purposes should be placed in a well-supervised trading account and marked to market.

Interest-Rate Swaps

Consistent with the general requirement that trading assets or liabilities be marked to market, a dealer or market maker in swap instruments is required to mark its swap trading book to fair value. While the Emerging Issues Task Force (EITF) has provided limited interpretations on interest-rate swaps used as hedges, authoritative standards from the FASB, AICPA, or SEC do not yet exist. In this vacuum, diverse industry practice has resulted. EITF Issue No. 84-7 applies to the early termination of swaps that hedge some financial instrument. According to this issue, gain or loss from early termination is to be deferred and amortized as a yield adjustment to the underlying financial instrument. Issue No. 84-36 applies if there is an underlying debt obligation on the balance sheet of the company entering into a swap. The company should account for the swap like a hedge of the obligation and record interest expense using the revised interest rate. Situations where the swap does not hedge an asset or liability were excluded from the scope of the two issues, other than to note a diversity of accounting treatment. Some accountants view the EITF's discussion of hedging as guidance for accounting for ''synthetic instruments'' (for example, the transformation of fixed-rate debt into floating-rate debt by use of an interest-rate swap) where there is no risk reduction per se. Interest-rate swaps denominated in a foreign currency, including cross-currency interest-rate swaps, are generally accounted for by analogy to the accounting guidance set forth in FASB 52. Financial institutions engaging in swaps should have written policies that govern the accounting for these instruments, and should be consistently following these policies.

Options

Options involve two parties: the writer (or seller) and the purchaser (or holder). The purchaser of an option has the right, but not the obligation, to purchase or sell the option's underlying instrument according to the terms specified in the option. The option writer, in return for receiving the option premium, is obligated to perform according to the terms of the option.

Purchased Options

When held as a trading asset, a purchased option is to be marked to market under GAAP for presentation in the financial statements. For regulatory reporting purposes, the call report instructions state that purchased options are generally not to be reported at market value. For call report purposes, the only purchased options that have specifically been permitted to be marked to market are those that have been used for trading purposes and have been placed in a well-supervised trading account.

Purchased options can be an effective hedge of anticipated transactions, where they can be exercised if the anticipated transaction matures into a firm commitment or can be allowed to lapse if the anticipated transaction does not occur. Alternatively, options can be used to protect against unfavorable price movements, but allow the institution to benefit from favorable price changes of the hedged items. Virtually no authoritative literature has been issued for the accounting of options. The AICPA released an issues paper in 1986 that proposed certain methods of accounting for options that included criteria for hedging that were similar to FASB 80.

The paper, however, is not authoritative. One recommendation of the report was to account for purchased options used for hedging purposes in two discrete amounts: (a) the intrinsic value (that is the difference, if positive, between the option's exercise price and the market price of the underlying instrument) and (b) the time value of the option. The former would be an adjustment to determining the gain or loss on exercise or expiration; the latter would be amortized over the term of the option. Another recommendation was that if the option qualifies as a hedge of an item carried at historical cost, changes in intrinsic value would be included in a separate component of equity. While parts of the issues paper have become industry practice, some of the approaches advocated, such as these two examples, are rarely seen.

For presentation in the call report, purchased options that are held for hedging purposes generally are to be recorded at cost and amortized over the term of the option. No periodic valuation for balance-sheet presentation of open positions is permitted.

Written options. By their inherent risk profile, written options, whether covered or not, do not generally qualify as a hedge for accounting purposes. The premium received by an option's writer should be deferred until the point at which the option either expires or is exercised. If the option is exercised, the premium is an adjustment to the amount realized on the sale of the underlying obligation. If the option expires out of the money, the premium is considered earned and is reported as other fee income. Options that are in the money (and thus an obligation to the writer) are to be marked to market, according to the SEC.

The call report instructions provide guidance for written ''standby contracts,'' which are a form of option. Standby contracts are to be valued at the lower of cost or market (since the written option is a liability, the absolute amount reported is the higher of cost (the premium received) or market value). Market value in this context is the loss exposure, which would be based on the difference between the option's strike price and the market price of the underlying instrument.

Purchased options that hedge foreign-exchange exposures related to anticipated transactions. In issuing guidance on foreign-currency hedges that use options (Issue No. 90-17), the EITF noted that FASB 52 did not specifically consider options. The EITF used certain elements from FASB 80 in identifying appropriate criteria for applying hedge-accounting treatment: the requirement that overall risk be reduced, that high correlation between the hedge position and the hedged items be present, and that anticipated transactions could be hedged if they are identifiable and probable. This guidance is narrowly applied to strategies using at-the-money options at the inception of the hedge. When it examined other option-based hedge strategies (Issue No. 91-4), the EITF was unable to reach a consensus because of objections by the SEC about the deferral of gains or losses related to anticipated transactions. The SEC also objected to any deferral of losses from written options, since to write options does not, in the SEC's view, reduce risk.

Netting or Offsetting On- and Off-Balance-Sheet Assets and Liabilities

The FASB issued Interpretation 39 in 1992, which went into effect for 1994 financial statements of banks and other companies. This interpretation applies to the netting of assets and liabilities arising from (i) ''traditional'' activities, such as loans and deposits, and (ii) OBS derivative instruments. The assets and liabilities from derivatives primarily are their fair value, or estimated market value, and the receivables and payables on these instruments. FIN 39 clarifies the definition of a ''right of setoff'' that GAAP has long indicated must exist before netting of assets and liabilities can occur in the balance sheet. One of the main purposes of FIN 39 was to clarify that FASB's earlier guidance on netting of assets and liabilities (TB 88-2) applies to amounts recognized for OBS derivative instruments as well.

Balance-sheet items arise from off-balance-sheet interest-rate and foreign-currency instruments primarily in two ways. First, those banking organizations and other companies that trade OBS derivative instruments (for example, interest-rate and currency swaps, forwards, and options) are required by GAAP to mark to market these positions by recording their fair values (estimated market values) on the balance sheet and recording any changes in these fair values (unrealized gains and losses) in earnings. Second, interest-rate and currency swaps have receivables and payables that accrue over time, reflecting expected cash inflows and outflows that must periodically be exchanged under these contracts, and these receivables and payables must be recorded on the balance sheet as assets and liabilities, respectively.[12]

Under FIN 39, setoff, or the netting of assets and liabilities to a particular counterparty, is not permitted unless all of the following four criteria are met:

- Two parties must owe each other determinable amounts.
- The reporting entity must have a right to set off its obligation with the amount due to it.
- The reporting entity must actually intend to set off these amounts.
- The right of setoff must be enforceable at law.

When all four criteria are met, a bank or other company may offset the related asset and liability and report the net amount in its GAAP financial statements. FIN 39 also indicates, without regard to the third criterion (the parties' intent), the netting of fair values of OBS derivative contracts executed with the counterparty under a legally enforceable master netting agreement is permitted. If any one of the other three criteria is not met, the fair value of contracts in a loss position with the counterparty *cannot* be offset against the fair value of contracts in a gain position with that counterparty, and the organization would be required to record gross unrealized gains on such contracts as assets and gross unrealized losses as liabilities.

Call Report Requirements

The call report instructions provide guidance on netting for purposes of reporting risk-based capital information.[13] Furthermore, the FFIEC, on an interim basis, adopted for the call report the provisions of FIN 39 that are applicable to derivative contracts, effective for 1994 call reports. The general instructions to the call report, however, explicitly prohibit the netting of assets and liabilities by banks *unless* specifically required by the instructions. Thus, FIN 39 is not to be applied to traditional balance-sheet assets and liabilities for call report purposes.

DISCLOSURE FOR SECURITIES AND FINANCIAL CONTRACTS

In addition to issuing authoritative guidance on methods of accounting (that is, how a particular transaction is to be reported on the balance sheet or statements of income or cash flow), the FASB (and SEC) also set standards for minimum disclosure of the financial activities, condition, and other issues that should be incorporated in a company's annual report. Information to meet these disclosure requirements is audited by the company's independent accountants and may be presented either as footnotes to the financial statements or incorporated in management's discussion and analysis (MD&A). In MD&A, management reviews in some detail the company's results from operations, its liquid resources and capital position, significant events occurring after the date of the financial statements, and other matters. MD&A is required for reports filed with the SEC, such as the annual 10-K and quarterly 10-Q. Since it is fixed-form, the call report does not have a direct analogue to MD&A. There is, however, considerable overlap as many of the call report's supporting schedules and memoranda state much of the information required under the disclosure standards of GAAP. The following section briefly describes the GAAP requirements for disclosure relating to financial instruments.

As an interim step in a project to improve the accounting for financial instruments, par-

12. In contrast, the notional amounts of off-balance-sheet derivative instruments, or the principal amounts of the underlying asset or assets to which the values of the contracts are indexed, are not recorded on the balance sheet. Note, however, that if the OBS instrument is carried at market value, that value will include any receivable or payable components. Thus, for those OBS instruments that are subject to a master netting agreement, the accrual components in fair value are also netted.

13. The risk-based capital guidelines provide generally that a credit-equivalent amount is calculated for each individual interest-rate and exchange-rate contract. The credit-equivalent amount is determined by summing the positive mark-to-market values of each contract with an estimate of the potential future credit exposure. The credit-equivalent amount is then assigned to the appropriate risk-weight category.

Netting of swaps and similar contracts is recognized for risk-based capital purposes only when accomplished through ''netting by novation.'' This is defined as a written bilateral contract between two counterparties under which any obligation to each other is automatically amalgamated with all other obligations for the same currency and value date, legally substituting one single net amount for the previous gross obligations.

ticularly OBS instruments, the FASB wrote new disclosure standards intended to increase the transparency of contractual terms, risks, and market values of both on- and off-balance-sheet financial instruments. To date, three standards have been written, requiring additional disclosure about instruments having certain risks (including a lack of diversification), the fair market value of financial instruments (including such classes as securities, loans, and deposits), and the discussion of the risk-management strategies when the company uses OBS instruments.

The first standard resulting from the financial instruments project was FASB 105, ''Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk.'' Under the standard, a company is required to describe the notional amounts and significant contractual terms for financial instruments that have off-balance-sheet risk of accounting loss.[14] Secondly, the company is required to disclose the amount of accounting loss that would occur as a result of credit risk.[15] As a part of the disclosure of credit risk, the company is required to discuss its policies for requiring collateral and a description of the collateral or other security supporting the contracts. Lastly, the company is required to report significant credit concentrations across all classes of financial instruments. This may be done by industry, region, or other economic characteristics. FASB 105 was amended by FASB 119 (see below) to require the disclosure of notional amount and significant contract terms of financial instruments without off-balance-sheet risk of loss (for example, purchased options) in addition to the disclosures described earlier. FASB 105 was required to be followed for annual reports beginning in 1991.

The second standard issued by the FASB was FASB 107, ''Disclosures about Fair Value of Financial Instruments,'' which was effective for the 1993 annual reports of institutions with assets of $150 million or more and will be effective for the 1996 annual reports of smaller institutions. Under the standard, a company is required to disclose the fair value of virtually all classes of financial instruments. The company should disclose its methods for estimating fair value, such as the use of market quotes or valuation techniques (and disclose the assumptions used if values are estimated) for instruments without active markets. FASB 107 requires that demand deposits be reported at face value and the value of long-term relationships and other intangibles not be taken into account, although these and other nonfinancial assets and liabilities may be separately disclosed. In response to criticisms from industry analysts about the difficulty in following some companies' disclosures, the FASB amended FASB 107 when it issued FASB 119, ''Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments.'' FASB 119 requires that the fair-value disclosure separate OBS instruments used as hedges from the instruments on the balance sheet being hedged. FASB 107 was also amended to require fair-value disclosure in a single place rather than scattered throughout the annual report.

In response to calls for further improvement in the disclosure of derivatives activities, FASB 119 requires a firm that issues or holds derivatives to differentiate in its disclosures between derivatives that it uses for trading purposes and derivatives used for risk-management or other end-user reasons.

- *Trading activities*. A dealer is required to report the fair value (both year-end and annual average) of its derivatives positions and to disaggregate derivatives trading profits. This disaggregation may be reported either for derivative instruments alone or broken down by some other method by the firm, such as lines of business, risk exposures (for example, interest-rate or foreign-exchange), or another method as long as trading profits from derivative instruments are disclosed. The FASB encouraged, but did not require, the disclosure of both year-end and average fair values of trading assets and liabilities that are not

14. An off-balance-sheet accounting loss occurs when there is the potential for loss because of market or credit risks that exceed the amount reported on the balance sheet for the OBS instrument. In other words, the loss in the event of a default or adverse market movement could exceed the reported value of the contract. For example, a purchased-put option does not have accounting risk of loss because the most that could be lost by the holder is the amount of the premium paid (of course, the economic loss would be the fair value of the option). The writer of the put, on the other hand, would have an accounting loss to the writer if it must pay cash to settle the contract in excess of the premium it received. Thus the writer has off-balance-sheet risk of loss while the holder does not.

15. For example, an interest-rate swap accounted for using the accrual method that has a market value of $1,000 and an accrued net receivable of $10 has an accounting risk of loss of only $10.

derivatives, whether they are financial instruments or nonfinancial items, to give a more comprehensive picture of the firm's trading pursuits.
- *End-user activities*. For derivatives not used in trading, but instead used for hedging or other risk-management purposes, a firm is now required to describe its objectives for using derivatives and discuss its strategies for achieving those objectives. The firm is also required to describe how it reports derivatives in its financial statements as well as give certain details (such as the amount of gains or losses explicitly deferred) about derivatives used to hedge anticipated transactions. The fair values of end-user derivatives must also be separately disclosed from the fair value of items hedged by the derivatives.

Finally, FASB 119 encourages a firm to disclose quantitative information, consistent with its method for managing risk, that would be useful to financial statement readers in assessing its activities. Suggested approaches include gap analyses, the effect of hypothetical price shocks on reported earnings, and the disclosure of value at risk at the report date and its average during the year. FASB 119 first applied to annual reports for year-end 1994.

1. To determine if policies, practices, procedures, and internal controls regarding investments are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To determine the scope and adequacy of the audit function.
4. To determine the overall quality of the investment portfolio and how that quality relates to the soundness of the bank.
5. To determine compliance with laws and regulations.
6. To initiate corrective action when policies, practices, procedures or internal controls are deficient or when violations of laws or regulations have been noted.

1. If selected for implementation, complete or update the ‘‘Investment Securities’’ section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal/external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the following examination procedures. Also, obtain a listing of any deficiencies noted in the latest review done by internal/external auditors and determine if corrections have been accomplished.
   a. Determine the extent and effectiveness of investment policy supervision by—
      - reviewing the abstracted minutes of the board of directors and/or appropriate committee minutes;
      - determining that proper authorizations have been made for investment officers or committees;
      - determining any limitations or restrictions on delegated authorities;
      - evaluating the sufficiency of analytical data used by the board or investment committee;
      - reviewing the reporting methods used by department supervisors and internal auditors to ensure compliance with established policy; and
      - preparing a memo for the examiner assigned ‘‘Duties and Responsibilities of Directors’’ and the examiner who is in charge of the international examination, if applicable, stating conclusions on the effectiveness of directors’ supervision of the domestic and/or international-division-investment policy. All conclusions should be documented.
4. Obtain the following:
   a. Trial balances of investment-account holdings and money market instruments, such as commercial paper, banker’s acceptances, negotiable certificates of deposit, securities purchased under agreements to resell, and federal funds sold. Identify any depository instruments placed through money brokers.
   b. A list of any assets carried in loans and discounts on which interest is exempt from federal income taxes and which are carried in the investment account on call reports.
   c. A list of open purchase and sale commitments.
   d. A schedule of all securities, forward placement contracts, futures contracts, contracts on exchange-traded puts and calls, option contracts on futures puts and calls, and standby contracts purchased and/or sold since the last examination.
   e. A maturity schedule of securities sold under repurchase agreements.
   f. A list of pledged assets and secured liabilities.
   g. A list of the names and addresses of all securities dealers doing business with the bank.
   h. A list of the bank’s personnel authorized to trade with dealers.
   i. A list of all U.S. government–guaranteed loans which are recorded and carried as an investment-account security.
   j. For international division and overseas branches, a list of investments—
      - held to comply with various foreign governmental regulations requiring such investments;
      - used to meet foreign reserve requirements;
      - required as stock exchange guarantees or used to enable the bank to provide securities services;
      - representing investment of surplus funds;
      - used to obtain telephone and telex services;
      - representing club and school memberships;
      - acquired through debts previously contracted;
      - representing minority interests in nonaffiliated companies;
      - representing trading-account securities;
      - representing equity interests in Edge Act and agreement corporations and foreign banks; and

   • held for other purposes.
5. Using updated data available from reports of condition, UBPR printouts, and investment advisor and correspondent bank portfolio analysis reports, obtain or prepare an analysis of investment and money market holdings that includes—
   a. a month-by-month schedule of par, book, and market values of issues maturing in one year;
   b. schedules of par, book, and market values of holdings in the investment portfolio (Those schedules should be indexed by maturity date. The schedule should be detailed by maturity dates over the following time periods: over one through five years, over five through 10 years, and over 10 years.);
   c. book-value totals of holdings by obligor or industry; related obligors or industries; geographic distribution; yield; and special characteristics, such as moral obligations, conversion, or warrant features;
   d. par value schedules of type I, II, and III investment holdings, by those legally defined types; and
   e. for the international division, a list of international investment holdings (foreign-currency amounts and U.S. dollar equivalents) to include—
      • descriptions of securities held (par, book, and market values),
      • names of issuers,
      • issuers' countries of domicile,
      • interest rates, and
      • pledged securities.
6. Review the reconcilement of investment and money market account(s) trial balances to general-ledger control account(s).
7. Using either an appropriate sampling technique or the asset-coverage method, select from the trial balance(s) international investments, municipal investments, and money market holdings for examination. If transaction volume permits, include all securities purchased since the last general examination in the population of items to be reviewed.
8. Perform the following procedures for each investment and money market holding selected in step 7:
   a. Check appropriate legal opinions or published data outlining legal status.
   b. If market prices are provided to the bank by an independent party (excludes affiliates and securities dealers selling investments to the bank) or if they are independently tested as a documented part of the bank's audit program, those prices should be accepted. If the independence of the prices cannot be established, test market values by reference to one of the following sources:
      • published quotations, if available
      • appraisals by outside pricing services, if performed
   c. If market prices are provided by the bank and cannot be verified by reference to published quotations or other sources, test those prices by using the ''comparative yield method'' to calculate approximate yield to maturity:

$$\text{Approximate Yield to Maturity} = \frac{\text{Annual Interest} + \dfrac{\text{Par Value} - \text{Book Value}}{\text{Number of Years to Maturity}}}{\tfrac{1}{2}\,(\text{Bank-Provided Market Price} + \text{Par Value})}$$

      • Compare the bank-provided market price and the examiner-calculated approximate yield to maturity to an independent publicly offered yield or market price for a similar type of investment with similar rating, trading volume, and maturity or call characteristics.
      • Compare nonrated issues to fourth-rated (BBB, Baa) bonds.
      • Investigate market-value variances in excess of 5 percent.
   d. For investments and money market obligations in the sample that are rated, compare the ratings provided to the most recent published ratings.

Before continuing, refer to steps 16 through 18. They should be performed in conjunction with steps 9 through 15. International-division holdings should be reviewed with domestic holdings to ensure compliance, when combined, with applicable legal requirements.

9. To the extent practical under the circumstances, perform credit analysis of—
   a. the obligors on securities purchased under agreements to resell, when the readily marketable value of the securities is not sufficient to satisfy the obligation;

b. all international investments, nonrated securities, and money market instruments selected in step 7 or acquired since the last examination;
c. all previously detailed or currently known speculative issues;
d. all defaulted issues; and
e. any issues contained in the current Interagency Country Exposure Review Committee credit schedule obtained from the international loan portfolio manager by—
   • comparing the schedule to the foreign securities trial balance obtained in step 4 to ascertain which foreign securities are to be included in Interagency Country Exposure Review Committee credits;
   • for each security so identified, transcribing the following appropriate information to a separate examiner's line sheet or a related examiner's credit line sheet:
     — amount (and U.S. dollar equivalent if a foreign currency) to include par, book, and market values
     — how and when acquired
     — maturity date(s)
     — default date, if appropriate
     — any pertinent comments; and
   • returning schedule and appropriate examiner's line sheet(s) to the examiner assigned ''International—Loan Portfolio Management.''

10. Review the most recent reports of examination of the bank's Edge Act and agreement corporation affiliates and foreign subsidiaries to determine their overall conditions. Also, compile data on Edge Act and agreement corporations and foreign subsidiaries necessary for the commercial report of examination (i.e., asset criticisms, transfer risk, and other material examination findings).
11. Classify speculative and defaulted issues according to the following standards (except those securities in the Interagency Country Exposure Review and other securities on which special instructions have been issued):
    a. The entire book value of speculative-grade municipal general obligation securities which are not in default will be classified substandard. Market depreciation on other speculative issues should be classified doubtful. The remaining book value usually is classified substandard.
    b. The entire book value of all defaulted municipal general obligation securities will be classified doubtful. Market depreciation on other defaulted bonds should be classified loss. The remaining book value usually is classified substandard.
    c. Market depreciation on nonexempt stock should be classified loss.
    d. Report comments should include—
       • description of issue;
       • how and when each issue was acquired;
       • default date, if appropriate;
       • date interest paid to;
       • rating at time of acquisition; and
       • comments supporting the classification.
12. Review the bank's maturity program by—
    a. Reviewing the maturity schedules.
       • Compare book and market values and, after considering the gain or loss on year-to-date sales, determine if the costs of selling intermediate and long-term issues appear prohibitive.
       • Determine if recent acquisitions show a trend toward lengthened or shortened maturities. Discuss such trends with management, particularly with regard to investment objectives approved by the investment committee.
    b. Reviewing the pledged asset and secured liability schedules and isolating pledged securities by maturity segment. Then determine the market value of securities pledged in excess of net secured liabilities.
    c. Reviewing the schedule of securities sold under repurchase agreement and determining if—
       • financing for securities purchases is provided via repurchase agreement by the securities dealer who originally sold the security to the bank,
       • funds acquired through the sale of securities under agreement to repurchase are invested in money market assets or if short-term repurchase agreements are being used to fund longer-term, fixed-rate assets,
       • the extent of matched asset repo and liability repo maturities and the overall effect on liquidity resulting from unmatched positions,

- the interest rate paid on securities sold under agreement to repurchase is appropriate relative to current money market rates, and
- the repurchase agreement is at the option of the buying or selling bank

d. Reviewing the list of open purchase and sale commitments and determining the effect of their completion on maturity scheduling.

e. Submitting investment portfolio information regarding the credit quality and practical liquidity of the investment portfolio to the examiner assigned Asset/Liability Management.

13. Consult with the examiner responsible for the Asset/Liability Management analysis to determine what information is needed to assess the bank's sensitivity to interest-rate fluctuations and its ability to meet short-term funding requirements. If requested, compile the information using bank records or other appropriate sources. Refer to the Instructions for the Report of Examination section of this manual for factors to be taken into account when compiling this information. Information which may be required to be furnished includes:
    a. market value of unpledged government and federal-agency securities maturing within one year
    b. market value of other unpledged government and federal-agency securities which would be sold without loss
    c. market value of unpledged municipal securities maturing within one year
    d. book value of money market instruments, such as banker's acceptances, commercial paper, and certificates of deposit. (Provide amounts for each category.)
    e. commitments to purchase and sell securities, including futures, forward, and standby contracts (Provide a description of the security contract, the purchase or sales price, and the settlement or expiration date.)

14. Determine whether the bank's investment policies and practices are satisfactorily balancing earnings and risk considerations by—
    a. using UBPR or average call report data to calculate investments as a percentage of total assets, average yields on U.S. government and nontaxable investments, and—
        - comparing results to peer-group statistics,
        - determining the reasons for significant variances from the norm, and
        - determining if trends are apparent and the reasons for such trends;
    b. calculating current market depreciation as a percentage of gross capital funds;
    c. reviewing the analysis of municipal and corporate issues by rating classification and—
        - determining the total in each rating class and the total of nonrated issues,
        - determining the total of nonrated investment securities issued by obligors located outside of the bank's service area (exclude U.S. government–guaranteed issues); and
        - reviewing acquisitions since the prior examination and ascertaining reasons for trends that may suggest a shift in the rated quality of investment holdings;
    d. reviewing coupon rates or yields (when available) and comparing those recently acquired investments and money market holdings with coupon rates or yields that appear high, or low, to similarly acquired instruments of analogous types, ratings, and maturity characteristics (Discuss significant rate or yield variances with management.);
    e. reviewing schedule of securities, futures, forward, and standby contracts purchased and sold since the last examination and determining whether the volume of trading is consistent with policy objectives (If the bank does not have a separate trading account, determine whether such an account should be established, including appropriate recordkeeping and controls.);
    f. if the majority of sales resulted in gains, determining if profit-taking is consistent with stated policy objectives or is motivated by anxiety for short-term income;
    g. determining whether the bank has discounted or has plans to discount future investment income by selling interest coupons in advance of interest payment dates; and
    h. reviewing the list of commitments to purchase or sell investments or money market investments (Determine the effect

of completion of these contracts on future earnings.).

15. Review the bank's federal income tax position and
    a. determine, by discussion with appropriate officer(s), if the bank is taking advantage of procedures to minimize tax liability in view of other investment objectives;
    b. review or compute actual and budgeted—
        - tax-exempt holdings as a percentage of total assets and
        - applicable income taxes as a percentage of net operating income before taxes; and
    c. discuss with management the tax implications of losses resulting from securities sales.
16. Determine that proper risk diversification exists within the portfolio by—
    a. reviewing totals of holdings by single obligor or industry, related obligors or industries, geographic distribution, yields, and securities that have special characteristics (include individual due from bank accounts from the list received from the bank or from the examiner assigned ‘‘Due from Banks’’ and all money market instruments) and—
        - detail, as concentrations, all holdings equaling 25 percent or more of capital funds and
        - list all holdings equaling at least 10 percent but less than 25 percent of capital funds and submit that information to the examiner assigned ‘‘Loan Portfolio Management’’ (These holdings will be combined with any additional advances in the lending areas.) and
    b. performing a credit analysis of all nonrated holdings determined to be a concentration if not performed in step 9.
17. If the bank is engaged in financial futures, exchange-traded puts and calls, forward placement, or standby contracts, determine if—
    a. the policy is specific enough to outline permissible contract strategies and their relationships to other banking activities;
    b. recordkeeping systems are sufficiently detailed to permit a determination of whether operating personnel have acted in accordance with authorized objectives;
    c. the board of directors or its designee has established specific contract position limits and reviews contract positions at least monthly to ascertain conformance with those limits;
    d. gross and net positions are within authorized positions and limits, and if trades were executed by persons authorized to trade futures; and
    e. the bank maintains general-ledger memorandum accounts or commitment registers which, at a minimum, include—
        - the type and amount of each contract,
        - the maturity date of each contract,
        - the current market price and cost of each contract, and
        - the amount held in margin accounts:
            — All futures contracts and forward and standby and options contracts are revalued on the basis of market or the lower of cost or market at each month-end.
            — Securities acquired as the result of completed contracts are valued at the lower of cost or market upon settlement.
            — Fee income received by the bank on standby contracts is accounted for properly.
            — Financial reports disclose futures, forwards, options, and standby activity.
            — The bank has instituted a system for monitoring credit-risk exposure in forward and standby contract activity.
            — The bank's internal controls, management reports, and audit procedures are adequate to ensure adherence to policy.
18. If the bank is engaged in financial futures, forward placement, options, or standby contracts, determine if the contracts have a reasonable correlation to the bank's business needs (including gap position) and capacity to fulfill its obligations under the contracts by—
    a. comparing the contract commitment and maturity dates to anticipated offset,
    b. reporting significant gaps to the examiner assigned ‘‘Asset/Liability Management’’ (refer to step 13),

c. comparing the amounts of outstanding contracts to the amounts of the anticipated offset,
d. ascertaining the extent of the correlation between expected interest-rate movements on the contracts and the anticipated offset, and
e. determining the effect of the loss recognition on future earnings, and, if significant, reporting it to the examiner assigned ''Analytical Review and Income and Expense.''

19. On the basis of pricings, ratings, and credit analyses performed above, and using the investments selected in step 7 or from lists previously obtained, test for compliance with applicable laws and regulations by—
a. determining if the bank holds type II or III investments that are predominantly speculative in nature or securities that are not marketable (12 CFR 1.3(b));
b. reviewing the recap of investment securities by legal types, as defined by 12 CFR 1, on the basis of the legal restrictions of 12 USC 24 and competent legal opinions, as follows:
   - If a type II or III security is readily marketable, and if the purchaser's judgment was based on evidence of the obligor's ability to perform, determine if the par value of such securities issued by a single obligor, which the bank owns or is committed to purchase, exceeds 10 percent of the bank's capital funds (12 CFR 1.5(a) and 1.7(a)).
   - If the holding of a type II or III security was based on a reliable estimate of the obligor's ability to perform, determine if the aggregate par value of such issues exceeds 5 percent of the bank's capital funds (12 CFR 1.5(b) and 1.7(b));
c. for those investment securities that are convertible into stock or which have stock purchase warrants attached—
   - determining if the book value has been written down to an amount that represents the investment value of the security, independent of the conversion or warrant provision (12 CFR 1.10) and
   - determining if the par values of other securities that have been ruled eligible for purchase are within specified capital limitations;
d. reviewing pledge agreements and secured liabilities and determining that—
   - proper custodial procedures have been followed,
   - eligible securities are pledged,
   - securities pledged are sufficient to secure the liability that requires securing,
   - Treasury Tax and Loan Remittance Option and Note Option are properly secured, and
   - private deposits are not being secured;

   (Information needed to perform the above steps will be contained in the pledge agreement; Treasury circulars 92 and 176, as amended.)

e. reviewing accounting procedures to determine that—
   - investment premiums are being extinguished by maturity or call dates (12 CFR 1.11),
   - premium amortization is charged to operating income (12 CFR 1.11),
   - accretion of discount is included in current income for banks required to use accrual accounting for reporting purposes,
   - accretion of bond discount requires a concurrent accrual of deferred income tax payable, and
   - securities gains or losses are reported net of applicable taxes and net gains or losses are reflected in the period in which they are realized;
f. determining if securities purchased under agreement to resell are in fact securities (not loans), are eligible for investment by the bank, and are within prescribed limits (12 USC 24 and 12 CFR 1). If not, determine whether the transaction is within applicable state legal lending limits;
g. reviewing securities sold under agreement to repurchase and determining whether they are, in fact, deposits (Regulation D, 12 CFR 204.2(a)(1));
h. determining that securities and money market investments held by foreign branches comply with section 211.3 of Regulation K—Foreign Branches of Member Banks (12 CFR 211.3) as to—
   - acquiring and holding securities (section 211.3(b)(3)) and

- underwriting, distributing, buying, and selling obligations of the national government of the country in which the branch is located (section 211.3(b)(4)); and

(Further considerations relating to the above are contained in other sections of Regulation K. Also review any applicable sections of Regulation T—Credit by Brokers and Dealers (12 CFR 220), Regulation X—Borrowers of Securities Credit (12 CFR 224), and Board Interpretations 6150 (regarding securities issued or guaranteed by the International Bank for Reconstruction and Development) and 6200 (regarding borrowing by a domestic broker from a foreign broker). Edge Act and agreement corporations are discussed in the Bank-Related Organizations section.

i. determining that the bank's equity investments in foreign banks comply with the provisions of section 25 of the Federal Reserve Act and section 211.5 of Regulation K as to—
  - investment limitations (section 211.5(b)) and
  - investment procedures (section 211.5(c)).

20. Test for compliance with other laws and regulations as follows:
    a. Review lists of affiliate relationships and lists of directors and principal officers and their interests.
       - Determine if the bank is an affiliate of a firm that primarily is engaged in underwriting or selling securities (12 USC 377).
       - Determine if directors or officers are engaged in or employed by firms that are engaged in similar activities (12 USC 78, 377, and 378). (It is an acceptable practice for bank officers to act as directors of securities companies not doing business in the United States, the stock of which is owned by the bank as authorized by the Board of Governors of the Federal Reserve System.)
       - Review the list of federal funds sold, securities purchased under agreements to resell, interest-bearing time deposits, and commercial paper, and determine if the bank is investing in money market instruments of affiliated banks or firms (section 23A, Federal Reserve Act, and 12 USC 371(c)).
       - Determine if transactions involving affiliates, insiders, or their interests have terms that are less favorable to the bank than transactions involving unrelated parties (sections 23A and 22, Federal Reserve Act, and 12 USC 371c, 375, 375a, and 375b).
    b. Determine if Federal Reserve stock equals 3 percent of the subject bank's booked capital and surplus accounts (Regulation I, 12 CFR 209).
    c. Review the nature and duration of federal-funds sales to determine if term federal funds are being sold in an amount exceeding the limit imposed by state legal lending limits.
21. With regard to potential unsafe and unsound investment practices and possible violations of the Securities Exchange Act of 1934, review the list of securities purchased and/or sold since the last examination and—
    a. determine if the bank engages one securities dealer or salesperson for virtually all transactions. If so—
       - evaluate the reasonableness of the relationship on the basis of the dealer's location and reputation and
       - compare purchase and sale prices to independently established market prices as of trade dates, if appropriate;
    b. determine if investment-account securities have been purchased from the bank's own trading department. If so—
       - independently establish the market price as of trade date,
       - review trading-account purchase and sale confirmations and determine if the security was transferred to the investment portfolio at market price, and
       - review controls designed to prevent dumping; and
    c. determine if the volume of trading activity in the investment portfolio appears unwarranted. If so—
       - review investment-account daily ledgers and transaction invoices to determine if sales were matched by a like amount of purchases,
       - determine whether the bank is financing a dealer's inventory,
       - compare purchase and sale prices with independently established market prices

as of trade dates, if appropriate. The carrying value should be determined by the market value of the securities as of the trade date, and
- cross-reference descriptive details on investment ledgers and purchase confirmations to the actual bonds or safekeeping receipts to determine if the bonds delivered are those purchased.

22. Discuss with appropriate officer(s) and prepare report comments on—
    a. defaulted issues;
    b. speculative issues;
    c. incomplete credit information;
    d. absence of legal opinions;
    e. significant changes in maturity scheduling;
    f. shifts in the rated quality of holdings;
    g. concentrations;
    h. unbalanced earnings and risk considerations;
    i. unsafe and unsound investment practices;
    j. apparent violations of laws, rulings, and regulations and the potential personal liability of the directorate;
    k. significant variances from peer-group statistics;
    l. market-value depreciation, if significant;
    m. weaknesses in supervision;
    n. policy deficiencies; and
    o. material problems being encountered by the bank's Edge Act and agreement corporation affiliates, and other related international concerns, that could affect the condition of the bank.
23. The following guidelines are to be implemented while reviewing securities participations, purchases/sales, swaps, or other transfers. The guidelines are designed to ensure that securities transfers involving state member banks, bank holding companies, and nonbank affiliates are carefully evaluated to determine if they were carried out to avoid classification and to determine the effect of the transfer on the condition of the institution. In addition, the guidelines are designed to ensure that the primary regulator of the other financial institution involved in the transfer is notified.
    a. Investigate any situations in which securities were transferred before the date of examination to determine if any were transferred to avoid possible criticism during the examination.
    b. Determine whether any of the securities transferred were nonperforming at the time of transfer, classified at the previous examination, depreciated or subinvestment-grade, or for any other reason were considered to be of questionable quality.
    c. Review the bank's policies and procedures to determine whether or not securities purchased by the bank are given an independent, complete, and adequate credit evaluation. If the bank is a holding company subsidiary or a member of a chain banking organization, review securities purchases or participations from affiliates or other known members of the chain to determine if the securities purchases are given an *arm's-length* and *independent* credit evaluation by the purchasing bank.
    d. Determine whether or not any bank purchases of securities from an affiliate are in conformance with section 23A, which generally prohibits purchases of low-quality assets from an affiliate.
    e. Determine that any securities purchased by the bank are properly reflected on its books at fair market value (fair market value should at a minimum reflect both the rate of return being earned on such assets and an appropriate risk premium). Determine that appropriate write-offs are taken on any securities sold by the bank at less than book value.
    f. Determine that transactions involving transfers of low-quality securities to the parent holding company or a nonbank affiliate are properly reflected at fair market value on the books of both the bank and the holding company affiliate.
    g. If poor-quality securities were transferred to or from another financial institution for which the Federal Reserve is not the primary regulator, prepare a memorandum to be submitted to the Reserve Bank supervisory personnel. The Reserve Bank will then inform the local office of the primary federal regulator of the other institution involved in the transfer. The memorandum should include the following information, as applicable:
        - name of originating and receiving institutions
        - type of securities involved and type of transfer (i.e., participation, purchase/sale, swap)

- date(s) of transfer
- total number and dollar amount of securities transferred
- status of the securities when transferred (e.g., rating, depreciation, nonperforming, classified, etc.)
- any other information that would be helpful to the other regulator.

24. Reach a conclusion regarding the quality of department management. Communicate your conclusion to the examiner assigned ‘‘Management Assessment’’ and the examiner who is in charge of the international examination, if applicable.
25. Update workpapers with any information that will facilitate future examination. If the bank has overseas branches, indicate those securities requiring review during the next overseas examination and the reasons for the review.

Review the bank's internal controls, policies, practices, and procedures regarding purchases, sales, and servicing of the investment portfolio. The bank's system should be documented in a complete, concise manner and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written investment securities policies, including WI securities, futures, and forward placement contracts, that outline—
   a. objectives,
   b. permissible types of investments,
   c. diversification guidelines to prevent undue concentration,
   d. maturity schedules,
   e. limitation on quality ratings,
   f. policies regarding exceptions to standard policy, and
   g. valuation procedures and frequency?
2. Are investment policies reviewed at least annually by the board to determine if they are compatible with changing market conditions?
3. Are securities designated at time of purchase as to whether they are investments for the portfolio or trading account?
4. Have policies been established governing the transfer of securities from the trading account to the investment-securities account?
5. Have limitations been imposed on the investment authority of officers?

*6. Do security transactions require dual authorization?

7. If the bank has due from commercial banks or other depository institutions time, federal funds sold, commercial paper, securities purchased under agreements to resell, or any other money market type of investment—
   a. is purchase or sale authority clearly defined,
   b. are purchases or sales reported to the board of directors or its investment committee,
   c. are maximums established for the amount of each type of asset,
   d. are maximums established for the amount of each type of asset that may be purchased from or sold to any one bank,
   e. do money market investment policies outline acceptable maturities, and
   f. have credit standards and review procedures been established?

CUSTODY OF SECURITIES

*8. Do procedures preclude the custodian of the bank securities from—
   a. having sole physical access to securities;
   b. preparing release documents without the approval of authorized persons;
   c. preparing release documents not subsequently examined or tested by a second custodian; and
   d. performing more than one of the following transactions: (1) execution of trades, (2) receipt or delivery of securities, (3) receipt and disbursement of proceeds?

*9. Are securities physically safeguarded to prevent loss or unauthorized removal or use?

10. Are securities, other than bearer securities, held only in the name or nominee of the bank?
11. When a negotiable certificate of deposit is acquired, is the certificate safeguarded in the same manner as any other negotiable investment instrument?

RECORDS

12. Do subsidiary records of investment securities show all pertinent data describing the security; its location; pledged or unpledged status; premium amortization; discount accretion; and interest earned, collected, and accrued?

*13. Is the preparation and posting of subsidiary records performed or reviewed by persons who do not also have sole custody of securities?

*14. Are subsidiary records reconciled at least monthly to the appropriate general-ledger accounts, and are reconciling items investigated by persons who do not also have sole custody of securities?

15. For international-division investments, are entries for U.S. dollar carrying values of foreign currency–denominated securities rechecked at inception by a second person?

PURCHASES, SALES, AND REDEMPTIONS

*16. Is the preparation and posting of security and open contractual commitments purchase, sale, and redemption records performed or reviewed by persons who do not also have sole custody of securities or authorization to execute trades?

*17. Are supporting documents, such as brokers' confirmations and account statements for recorded purchases and sales checked or reviewed subsequently by persons who do not also have sole custody of securities or authorization to execute trades?

*18. Are purchase confirmations compared to delivered securities or safekeeping receipts to determine if the securities delivered are the securities purchased?

FUTURES CONTRACTS, FORWARD PLACEMENT CONTROLS

19. Do futures and forward contract policies—
    a. outline specific strategies and
    b. relate permissible strategies to other banking activities?
20. Are the formalized procedures used by the trader—
    a. documented in a manual and
    b. approved by the board or an appropriate board committee?
21. Are the bank's futures commission merchant(s) and/or forward brokers—
    a. notified in writing to trade with only those persons authorized as traders and
    b. notified in writing of revocation of trading authority?
22. Has the bank established futures and forward trading limits—
    a. for individual traders,
    b. for total outstanding contracts,
    c. which are endorsed by the board or an appropriate board committee, and
    d. the basis of which is fully explained?
23. Does the bank obtain prior written approval detailing amount of, duration, and reason—
    a. for deviations from individual limits and
    b. for deviations from gross trading limits?
24. Are these exceptions subsequently submitted to the board or an appropriate board committee for ratification?
25. Does the trader prepare a prenumbered trade ticket?
26. Does the trade ticket contain all of the following information:
    a. trade date
    b. purchase or sale
    c. contract description
    d. quantity
    e. price
    f. reason for trade
    g. reference to the position being matched (immediate or future case settlement)
    h. signature of trader
27. Are the accounting records maintained and controlled by persons who cannot initiate trades?
28. Are accounting procedures documented in a procedures manual?
29. Are all incoming trade confirmations—
    a. received by someone independent of the trading and recordkeeping functions and
    b. verified to the trade tickets by this independent party?
30. Does the bank maintain general-ledger control accounts disclosing, at a minimum—
    a. futures or forward contracts memoranda accounts,
    b. deferred gains or losses, and
    c. margin deposits?
31. Are futures and forward contracts activities—
    a. supported by detailed subsidiary records and
    b. agreed daily to general-ledger controls by someone who is not authorized to prepare general-ledger entries?

32. Do periodic statements received from futures commission merchants reflect—
    a. trading activity for the period,
    b. open positions at the end of the period,
    c. market value of open positions,
    d. unrealized gains and losses, and
    e. cash balances in accounts?
33. Are all of these periodic statements—
    a. received by someone independent of both the trading and recordkeeping functions and
    b. reconciled to all of the bank's accounting records?
34. Are the market prices reflected on the statements—
    a. verified with listed prices from a published source and
    b. used to recompute gains and losses?
35. Are daily reports of unusual increases in trading activity reviewed by senior management?
36. Are weekly reports prepared for an appropriate board committee which reflect—
    a. all trading activity for the week,
    b. open positions at the end of the week,
    c. market value of open positions,
    d. unrealized gains and losses,
    e. total trading limits outstanding for the bank, and
    f. total trading limits for each authorized trader?
37. Is the futures and forward contracts portfolio revalued monthly to market value or to the lower of cost or market?
38. Are revaluation prices provided by persons or sources totally independent of the trading function?

OTHER

39. Does the board of directors receive regular reports on domestic and international-division investment securities which include—
    a. valuations,
    b. maturity distributions,
    c. average yield, and
    d. reasons for holding and benefits received (international-division and overseas holdings only)?
40. Are purchases, exchanges, and sales of securities and open contractual commitments ratified by action of the board of directors or its investment committee and thereby made a matter of record in the minutes?

CONCLUSION

41. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly and indicate any additional examination procedures deemed necessary.
42. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).